

MICROFINANCE SUPPORT PROJECT
PROGRESS REPORT
AS OF 12/31/01
AND
ACTION PLAN THROUGH MARCH 2003

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I. EXECUTIVE SUMMARY

1. Introduction

This progress report is divided into four sections. The executive summary is followed by a second section which reports on the activities and accomplishments for the period from June 30, 2001 to December 31, 2001. In this same section we also present an analysis of the accomplishments vs. the work plan, progress against specific project indicators, as well as an analysis of the project's finances (expenditures to date and projections). The third section of this report contains a detailed work plan and level of effort table for the remaining fifteen months of the project. The fourth section presents additional details on project activities carried out during the semester in a series of annexes.

The semester covered by this report was the most active and the most productive six month period under the technical assistance contract managed by CARANA Corporation under subcontract to KPMG Barents. Specific and intensive technical assistance and training activities were carried out with key FPVOs in Honduras and this is bringing about the desired changes in these institutions. This FPVO specific assistance has been the focus of our work plan since the beginning of the project. However, general support in a variety of areas designed to improve the microfinance environment in Honduras, such as the establishment of a credit bureau and assistance in the implementation of the new law governing FPVOs in Honduras, was also provided during the semester and as detailed in our report, has been very successful.

2. FPVO Level Assistance

In general, technical assistance and training to FPVOs provided under this contract can be grouped into five general areas. For the most part all of the FPVOs that CARANA is working with are receiving assistance in most, if not all, of these five areas. These five areas are:

- Credit
 - Simplification of procedures and formats
 - Improving internal controls and field and branch supervision
 - Modification to and updating of the credit methodology (ies) used
- Human Resources
 - Salaries and incentive plans
 - Profiles of key personnel (to be used in hiring new personnel)
 - Preparation of personnel manuals (organization, job descriptions and salaries)

- Marketing
 - Marketing studies
 - Identifying and capturing new clients
 - Development of new products
 - Loan officer incentive systems
 - Promotion and promotional strategies
- Organization and Strategies
 - Understanding the new FPVO law
 - Strategic and business planning
- Internal Audit
 - Focus of the internal audit function in a regulated environment
 - Improving the internal audit function

Technical assistance and training activities remain focused on five principal FPVOs: FINCA, World Relief of Honduras, Covelo Retail Operations, Hermandad de Honduras and ODEF¹. Our support to these institutions reflects the diagnostic analysis carried out on each of these institutions in the beginning of the project and mutually agreed upon work plans. These FPVOs are implementing our recommendations and have begun to see positive results:

- All five of the principal FPVOs have made the decision to adopt a pilot program based on our recommendations and are currently implementing them (against a target of 4 for this period).
- Two of these FPVOs (FINCA and Hermandad) have progressed far enough along with the pilot program to have made the decision to move forward and implement these recommendations across the whole organization (against a target of 2 for this period). Initial results from the other pilot programs suggest that these too will result in a roll-out throughout their respective institutions.
- As a result of technical assistance provided in 2000, FINSOL became the first of the microfinance institutions to bypass the commercial banking system for its disbursement and collection procedures by implementing its own cash disbursement and collection functions. This has led to improved client service and satisfaction and more efficient operations.
- As a result of assistance provided to ODEF in marketing (market and demand analysis), ODEF's new offices in La Ceiba and La Entrada have exceeded their targets for the first year of operations in both the number of clients and loan levels. These offices are doing better than its competitors in these same areas even though these competitors have been present in these areas for a longer period of time.

¹ FINSOL has also received some assistance under the project, but at the request of the USAID Mission in early 2001 CARANA phased out assistance to FINSOL given that it was receiving assistance directly from ACCION International.

- At least three of the FPVOs (Covelo, Hermandad de Honduras and ODEF) have made commitments to transition to fully regulated FPVOs under the new law governing FPVOs in Honduras (against a target of 2 for this period). CARANA has put together a support program to help these FPVOs understand the requirements under the new law and how to prepare for this transition. The other two (FINCA and World Relief of Honduras) have expressed interest and will most probably make the commitment in early 2002.

At the time of preparation of this report (mid January 2002), the FPVOs had still not closed their accounting for the period ending December 31, 2001 and consequently have not yet provided CARANA with the specific information required to compare actual results against the targets set for them in early 2001 against a variety of "results indicators". These results indicators were developed at USAID's request to assist them in monitoring the progress of individual FPVOs under out project, and consisted of nine key indicators or ratios. Once this data is prepared and made available to CARANA, we will prepare a separate report for USAID discussing the actual vs. projected results indicators for the period, along with an analysis of any variances that may occur. Preliminary data does indicate that the FPVOs appear to be meeting or exceeding most of their respective indicators.

3. Other Project Activities

In addition to the technical assistance provided directly to FPVOs as discussed above, the project also provides support in a number of areas that are designed to benefit the sector in general and improve the environment within which microfinance institutions operate. Key activities and accomplishments in this area are highlighted below:

- A review of the SIEM Management Information System used by key FPVOs in Honduras was carried out as planned. The analysis revealed significant weaknesses in the current MIS which affects not only the operations of these FPVOs today, but also their ability to continue to grow in the future and eventually comply with the requirements of the new law governing FPVOs. CARANA staff is currently working with Covelo and USAID to identify possible solutions to this problem.
- CARANA provided the lead trainers on two modules under the program to support the Diploma in Microfinance being sponsored by Covelo and the University of Honduras: "Successful experiences in Microfinance in Latin America"; and, "The Marketing Mix in Microfinance Institutions".
- During the semester, CARANA staff implemented two workshops in a series on the use of the AIMS - SEEP Impact tools. The first workshop focused on the Client Desertion tool (survey methodology), and the second workshop focused on the Client Satisfaction tool. The AIMS - SEEP Impact tools were developed under a project sponsored by USAID Washington and have been adapted for use in Honduras.

- In an intensive effort throughout the year, CARANA staff worked closely with the management and Board of Directors of the Covelo Foundation in the process of conceptualizing, engineering, and managing a strategy and a reorganization plan for Covelo's operations within the new legal / regulatory environment. The process culminated with a presentation made to the Covelo Board of Directors and resulted in the complete approval of the proposed reorganization, implementation plan and timeline. This reorganization will result in the separation of the current Foundation into three distinct legal entities made up of a holding company and two new independent FPVOs operating under the new FPVO law: A second story wholesale lending operation serving microfinance FPVOs; and, and a retail microfinance operation. This accomplishment exceeded all expectations in terms of scope and timing for this initiative.
- During the semester, DataCrédito, the credit bureau supported initially under this project signed contracts with more than 90 different companies to provide services. The list of clients includes the most important commercial banks in the country, large retail and commercial operations, and also includes some of the principal FPVOs in Honduras. This credit bureau is now entering the operational phase of the program one full year ahead of schedule.
- CARANA staff also worked to support the implementation of the new law governing FPVOs in Honduras. Our staff developed the audit and supervision manuals required under the law, and these were submitted to the Banking Commission in September of 2001. CARANA staff also prepared an analysis of the legislation for USAID in July of this year.

4. Work Plan for the Remaining Fifteen Months of the Project

In section III of this report, CARANA has provided a detailed work plan for the remaining fifteen months of the project. This work plan reflects a desire to consolidate technical assistance and training at the FPVO level. Other forms of technical assistance (e.g. support to the environment affecting microfinance in Honduras) are being phased out as planned.

Most of the technical assistance and training activities will be implemented by our long term resident staff with support from a small group of short term consultants, all of whom have already worked on this project. The work plan for each institution which is presented in section III of this report has been discussed with and approved by the management of each of the institutions.

5. Financial Data

As of December 31, 2001 CARANA has incurred a total of \$1,346,541 in labor and expenses out of a total budget of \$2,347,575. This level of spending is in line with the work plan and the projected level of expenditures through to the end of the project. CARANA expects to incur approximately \$200,000 in labor and expenses during each of

the remaining five quarters of the project. As a result, we estimate that we will utilize 100% of the budget by March 31, 2002.

While overall dollar expenditures are on track, CARANA expects that it will have to request a line item adjustment within the overall budget. This line item adjustment reflects the fact that since July of 2001 Other Direct Costs (allowances, travel, equipment, other direct costs and NICRA G&A) have increased dramatically as a result of increased project activity, the establishment of a separate independent office outside of Covelo, and an increase in project resident staff.

6. Key Issues Affecting the Project at this Time

The project is not facing any major issues at this time. However, we have identified four areas that are currently not being addressed under this project (due to budget limitations or by design) which we believe will have a negative affect in the development of the microfinance sector in Honduras in the long run unless they are addressed.

- a. Training and support to the National Banking Commission on the implementation of the new law governing FPVOs in Honduras

Under this microfinance support project, CARANA's support to the National Banking Commission in its efforts to implement the new law governing microfinance institutions has been limited to the drafting of the audit and inspection manuals called for under that law. This task was completed in August of 2001. However, there is no doubt that the National Banking Commission will require assistance in establishing the supervisory body within the Superintendent of Banking as well as for the training of its staff in the implementation of a streamlined and efficient supervision process. Support for the FPVOs in this area would center on the establishment of a real internal control function through technical assistance and training designed to meet the requirements of the new law.

Experience from other countries has shown that the regulatory body supervising microfinance institutions needs to understand microfinance lending, and particularly the differences between microfinance lending and the activities carried out by traditional commercial banks and "financieras". This understanding is necessary so that the National Banking Commission can carry out its supervisory role efficiently while at the same time stimulating healthy growth in the sector. Not assisting the National Banking Commission in Honduras at a time when they are requesting this assistance and are very receptive could have adverse affects on the sector (i.e., over regulation, excessive paperwork and bureaucracy, inefficient supervision, etc.).

- b. The need to develop a better MIS solution for FPVOs in Honduras

there are critical problems with the MIS system currently being used by the key microfinance institutions in the Covelo network. The problems with the current system affect the operations of these microfinance institutions as well as their ability to

effectively monitor trends in their loan portfolios. The existing MIS will also make it difficult for the FPVOs and the Banking Commission to work together to efficiently carry out the supervision of these FPVOs as required under the new law.

CARANA's consultants believe that the development of an MIS system would contribute enormously in consolidating the technical assistance at the FPVO level. An MIS system that corrects the problems of the current system would facilitate the implementation of many of the recommendations being made by CARANA's staff (delegation of authority, streamlined credit procedures, improved decision making, better risk management, better management reporting, better portfolio analysis, variable incentives for loan officers, etc.).

An MIS solution should correct the limitation discussed in our report and will require that some organization be willing to invest the resources to develop such a system and to maintain it over time. CARANA staff is currently discussing the problem with Covelo's management with the hope that Covelo's management will take an active role in developing a long term MIS solution in Honduras.

- c. Additional assistance to Tier III FPVOs and other FPVOs that have not received intensive technical assistance under this project

As explained in the initial work plan submitted in June of 2000, CARANA and Covelo made a strategic decision to focus on several key FPVOs within the Covelo network (Tier I and Tier II institutions). These Tier III FPVOs represent a large number of microfinance clients in Honduras (more than 25,000) making them an important segment in the microfinance community (three of them have over 5,000 clients each). The law governing FPVOs will also apply to these institutions, and as a result, we believe that many of them will require some technical assistance in the future in order to successfully transition to regulated FPVOs in the future.

FINSOL, which is an institution that received assistance from CARANA in the initial phases of the project, stopped receiving technical assistance from CARANA when it began to receive assistance directly from ACCION International. However, this assistance has not met their expectations and they are again asking for assistance under the microfinance support project in a variety of areas. FINSOL has received valuable assistance from USAID in the past and became the first regulated microfinance institution in Honduras. Today it faces new challenges and it is experiencing new difficulties which should be addressed soon.

- d. Follow-up assistance to Covelo reorganization

During the last year, CARANA has provided valuable technical assistance to Covelo's management and Board of Directors regarding the restructuring of the Covelo Foundation. The result of this has been a decision by the Board of Directors to restructure the organization and will result in the legal separation of the retail and wholesale credit operations much sooner than anticipated. This restructuring will allow

Covelo to comply with the new law governing FPVOs and will also provide it with the flexibility to carry out new activities supporting the microfinance sector in the future. CARANA's involvement in the reorganization process was finalized with the Board's approval of the strategy and financial projections in November of 2001. Covelo has requested additional assistance in this area, however due to budget restrictions, we have not scheduled any assistance for this initiative in the remaining fifteen months of the project.

II. PROGRESS REPORT AS OF DECEMBER 31, 2001

A. INTRODUCTION

The semester covering the period from July through December 2001 was the most active six month period under the technical assistance contract managed by CARANA Corporation (acting as a subcontractor to KPMG Barents under its contract with USAID / Honduras). A second resident staff member was hired to assist in providing direct technical assistance and training support to selected FPVOs in Honduras. In addition to direct support to FPVOs, CARANA staff and consultants in Honduras carried out additional activities designed to improve the overall environment for microcredit development in Honduras. These additional tasks included assistance with the establishment of the new FPVO law governing microfinance institutions in Honduras, continued support to the establishment of a credit bureau in Honduras, and assistance to the Covelo Foundation in its restructuring efforts. Specific training and support activities also included the introduction of survey techniques and a methodology for measuring client satisfaction and client desertion in microfinance institutions, a methodology which will eventually be used to measure the economic impact of microcredit on its clients and the community.

In addition to being the most active six month period under this project to date the CARANA team also feels that it was the most productive. Great strides were made with individual FPVOs in implementing our technical assistance proposals designed to improve their microfinance operations. Many of these institutions are now actively implementing pilot programs based on our recommendations, and others are ready to move beyond the pilot phase to implement these recommendations across the whole organization. A great deal of progress has also been achieved in support of the environment in general as is further detailed in the sections below.

B. TECHNICAL ASSISTANCE AND TRAINING ACTIVITIES

1. Introduction

In previous progress reports, CARANA has always presented technical assistance and training activities in separate sections of its progress report. However, for this and future reports we have decided to combine the two activities into one section reflecting the fact that both activities support each other under our project more intensely than ever before. While in the past, training activities carried out under this project tended to be more general in nature and were made available to a wide range of institutions, beginning in early 2001, our consultant team in Honduras began to develop specific training activities designed to support the technical assistance activities being carried out at the institutional level. For example, if technical assistance to an institution was focused on improving the credit analysis of clients, then as part of the technical assistance process a specific training session would be developed for loan officers on the subject using real clients and customer information. As a result, it becomes more difficult to separate technical assistance and training activities at the FPVO level.

This type of institution specific training activity which directly supports the technical assistance activity being carried for each FPVO has become the norm in the second semester of 2001. However, we do continue to conduct some general training activities that are available to all microfinance institutions and these are discussed at the end of this section.

During this current semester, CARANA Corporation focused on two main types of technical assistance activities and training activities: Those activities provided directly to FPVOs in the Covelos network; and, technical assistance and training activities that were geared towards improving the environment within which these FPVOs operate in Honduras.

Technical assistance and training provided directly to FPVOs for the most part represented a continuation of a process that began over a year ago when after a diagnostic phase CARANA and each of the FPVOs formally developed a work plan focusing on key areas. This type of continuous support is necessary to insure that each of the institutions understands the recommendations that are being made, implements them correctly in a pilot effort, and then makes the appropriate adjustments in order to implement these recommendations across the whole organization.

Specific activities by key institution are detailed in the sections below.

2. Technical Assistance and Training to FINCA Honduras

In April of 2001, FINCA's new management began the implementation of a "Stabilization Plan" which would take five months to implement, and which also resulted in a reorganization of the institution and a high level of employee turnover. In support of this effort to stabilize and strengthen the institution, CARANA consultants have dedicated a great deal of effort to this institution during the year. The results have been very positive, and we believe that this institution will emerge from 2001 much stronger than before and ready to continue its growth in the microfinance arena in Honduras.

The focus of CARANA's technical assistance activities with FINCA since the beginning of the project has been on strengthening credit procedures. In recent months we have also worked to improve internal control procedures as well as the establishment of a budgeting process that will introduce the concept of profit centers at the branch and regional levels. During this semester we have supported their efforts to implement a pilot program in the Northern Zone (San Pedro, Progreso, Cortez and Medina) based on our recommendations. CARANA consultant Henry Cardona spent a total of ten weeks in the field working with FINCA's managers and credit personnel to fine tune this process in a series of activities designed to support the successful conclusion of these pilot programs. Specific activities include:

- Multiple training sessions with managers, supervisors and loan officers designed to simplify and improve the evaluation of potential clients (microentrepreneurs). Each of the training programs included the development of specific handouts and materials using real situations and actual clients.
- Field visits with the loan officers and their supervisors and managers to demonstrate the practical application of our recommendations. These field visits were later discussed in follow-up training sessions. More importantly, this process has helped to bring about a consensus on the proper procedures for identifying and analyzing potential clients.
- Design and instructions for a promotional brochure and other materials aimed at identifying and capturing new clients.
- Participation by our consultant in potential client promotional talks and the formation of new village banks. This participation resulted in specific recommendations on improving the promotional efforts and the process of forming new village banks. This also led to specific recommendations on how to better organize the village banks, how to set initial credit levels, and how to better supervise the work of the loan officers.
- Participation by our consultant in staff planning meetings which resulted in a revision to the operating plan (expansion and productivity) for the period October to December 2001. Our consultant also provided a better methodology for setting targets on the formation of new village banks.

In August, CARANA staff also conducted a formal training session for thirty five of FINCA's employees specifically on the topic of Internal Control Mechanisms. Topics covered included a better understanding of what is meant by Internal Control, the shared responsibilities at all levels inherent in an improved internal control system, as well as an understanding of what the more common risks that an FPVO faces. The emphasis on internal control mechanisms is important for FINCA given some of the internal control problems it has faced in the past, which led to a shakeup of management and operating personnel and a decline in its overall number of clients.

Of all of the FPVOs that CARANA is currently working with, FINCA has been the most receptive and has progressed the furthest in the implementation of our recommendations. FINCA has carried out a pilot program based on our recommendations in the Northern Zone, and has made appropriate modifications to proposed recommendations based on that pilot program. FINCA is now preparing to implement these recommendations across all of its branches, and our support in the coming months will include some assistance in this roll-out of the pilot experience.

Annexes B, C, and D of this report contain English translations of the executive summaries of the consultant's report for the assignments carried out in August and

October of 2001, as well as the summary of the course on internal controls carried out with FINCA staff in August.

3. Technical Assistance and Training to World Relief Honduras

Activities to support World Relief of Honduras (WRH) have focused primarily on its credit operations, specifically in the simplification of formats and procedures, improving the credit methodology, and improving the internal control and supervision functions. Our consultants have also supported WRH's management in the preparation of the year 2002 operating plan. Greater detail on our activities in support of WRH are presented in the report titled "Technical Assistance and Training Activities in Support of World Relief of Honduras During the Second Semester of 2001" dated December 2001. The executive summary of this report has been translated to English and is presented in Annex E of this report.

WRH is implementing most of our recommendations in a two phased approach. In the first phase, it is working to implement the new forms and procedures related to the credit evaluation process. It is also working to finalize the new general credit regulations and procedures, as well as the general regulations and procedures for past due credits. This also includes implementing modifications to the seasonal credits offered to its clients. In a second phase CARANA consultants will assist WRH in the process of decentralizing its credit operations, modify its promotional and training materials used with its clients, and assistance with the design of a system which will allow WRH to comply with the requirements of the National Banking Commission under the new law for FPVOs.

With regards to the implementation of the new forms and procedures for credit evaluation, WRH has now completed the training of the branch managers and the loan supervisors, and is now in the process of making final adjustments for implementation in a pilot program. The pilot program will allow WRH and CARANA consultants an opportunity to test these changes in the field before making final adjustments for a roll-out throughout the organization.

With regards to the new general credit regulations, the committee created by management to review these has completed its task, and they are currently in the hands of the general manager for final review and approval prior to implementation.

As discussed in greater detail in section II.B.9, CARANA consultants also supported WRH's management in the preparation of the 2002 operating plan. This review also included a review of WRH's Vision, Mission and Strategic Objectives, identifying the specific strategies that the institution will focus on in order to achieve its growth targets for the next year. These are: a) Greater levels of client retention (lowering client desertion rates); b) Reducing overall credit in arrears; and, c) Increasing the number of clients. Our staff has also worked with management in helping them to establish a better tracking of these variables so they can monitor progress against their targets more effectively.

We are pleased with the progress that WRH is making based on our recommendations. Along with FINCA, these two institutions have made the most progress and have begun to see the benefits of implementing our recommendations. Our work plan for the coming fifteen months reflects the progress already made by WRH and their ability and willingness to absorb technical assistance.

4. Technical Assistance and Training to Covelo's Retail Lending Operations

In March of 2001, CARANA staff completed a first round of technical assistance with Covelo, following up on the diagnostic work completed in 2000². Unfortunately, Covelo staff did not react immediately to our written report and recommendations. It was not until the second semester of this year that Covelo staff was able to provide CARANA with a response to the consultant's written report along with a request for additional support in implementation. Since then, however, Covelo has been moving with a greater sense of urgency in three areas: a) The simplification of procedures and formats relating to the solidarity lending and individual lending programs; b) The design of a new incentive plan for loan officers; and, c) Marketing.

Greater detail on the work carried out on in support of Covelo's retail operations was presented in the report titled "Technical Assistance and Training Activities in Support of Covelo's Retail Credit Operations in the Second Semester of 2001" dated December 2001. An English translation of the Executive Summary is provided in Annex F of this report.

a. Simplification of procedures and formats

The focus in this area has been on the simplification of the procedures and formats relating to the credit analysis and approval process. While all of the institutions we are working with have been using a rather cumbersome and unrealistic process, the design of a simplified credit analysis system has varied by institution and by product. This is mostly due to the special characteristics of each institution, and specifically, their willingness (or unwillingness) to decentralize the loan approval process at this time.

In the last three months of the year, significant progress was made. The suggested changes to the credit evaluation and approval system were first reviewed and approved by key managers in the credit department, and then reviewed carefully with the heads of selected branches (Pedregal y Guanacaste) and additional modifications were made based on their input. This step was followed by a training program with the heads of these agencies as well as their loan officers which in turn was followed by an initial test of these new procedures and formats. The next step will be to initiate the pilot program in these branches prior to final modifications and a roll-out across the entire institution.

² The technical assistance for Covelo discussed in this section is in addition to the technical assistance to the Foundation's management in the reorganization process that it is currently undertaking, which is discussed in section II. C of this report.

b. Design of a new incentive program for loan officers

The design of an appropriate incentive program is very important for a microfinance institution looking to attract new quality clients while retaining existing clients that have successfully repaid their loans. Almost all of the institutions we are working with in Honduras have had problems with the latter and Covelo is no exception. While we are specifically working with these institutions in helping them to better understand the issues behind client desertion, the implementation of the "right" incentive plan for loan officers that balances new clients with the retention of old clients is important.

As part of our assistance to Covelo, we provided the general manager of the retail lending program with a recommended system for their review, approval, and implementation. The basic plan looks to motivate loan officers to act in a manner which will lead to a growth in the loan portfolio, while at the same time leading to a decline in delinquency rates. The plan is currently being reviewed by Covelo's management.

c. Assistance in marketing

In September, CARANA consultant Luis Ludeñas provided technical assistance to Covelo in the area of Marketing in support of this institution's efforts to stimulate growth in its loan portfolio. This assignment responded to a series of concerns in this area, one of the most important being that for the first time, in the first six months of 2001 Covelo's growth rate in terms of loan portfolio and the number of clients had fallen below the market's growth rate, signaling a decline in market share for this year if this trend continues.

As part of this work, an analysis of Covelo's key indicators and targets was conducted, and this yielded some interesting results. For example, the analysis of Covelo's branches revealed that very few branches were able to meet the monthly targets that were set for them (i.e., number of clients, loan volume). The analysis also showed that 10 out of the 17 branches in the Covelo network (59%) were responsible for between 75% (number of clients) and 80% (loan volume) of the overall performance, indicating that some branches were clearly under performing. Other conclusions from this analysis showed that the rate of new clients per branch per month was very low and that the client to loan officer ratio was below the average seen in other FPVOs in Honduras (160 vs. an average of 205).

The recommendations made by our consultant included the following:

- Implementation of improved tools for tracking the productivity of each branch and loan officer within each branch.
- Improved planning and reporting systems which will allow for the more efficient utilization of the loan officer's time in the field and which provides more timely information to management on the loan officer's efforts.

- Introduction of a new incentive system to be used with a group of loan officers which sets a very low fixed salary and a relatively high variable commission based on performance.
- The eventual introduction of a group of officers dedicated exclusively to sales (capturing new clients / new loans).
- Introduction of a specific marketing campaign motivating current clients to provide referral clients to Covelo.

Upon culmination of this study, the consultant presented a separate report titled "Assistance in Marketing for the Covelo Foundation" dated September 2001. The English translation of the executive summary of this report is presented in Annex G of this report.

5. Technical Assistance and Training to Hermandad de Honduras

In addition to the work carried out in the area of institutional strengthening discussed in section II.B.9. below, during the six month period covered by this report, CARANA staff worked with Hermandad de Honduras (HDH) in the development of a basic incentive plan for loan officers and in marketing. Additional support has also been provided to the institution in the simplification of procedures and formats which was initially implemented in that institution earlier in the year.

a. Design of a new incentive program for loan officers

The work carried out with HDH in the development and implementation of a loan officer incentive plan is the same as that discussed above in the discussion on Covelo, although to some extent, we have progressed further on this topic with HDH. In the case of this institution, we have provided management with a manual and an excel spreadsheet for calculating the incentives, and we have also made presentations to the general manager, the credit manager and the personnel manager and staff. A presentation was also made to several members of the Board of Directors so that they could better understand the recommendations. At this time, the proposal is pending final discussion and approval by the Board of Directors prior to its implementation. CARANA anticipates its rapid approval, and will then assist management with the implementation of this system.

b. Marketing support

Specific assistance was provided to HDH in the area of Marketing which focused on the geographic area that this institution concentrates on. This support specifically analyzed market potential in its area of influence and the productivity of its loan officers in achieving adequate market penetration and coverage. In addition to working with and training their staff in this type of market analysis, new potential growth areas were identified. These areas include pockets within areas currently being served by the institution, but also identified additional zones (Intibuca, La Paz, and Santa Barbara) that

HDH could target in the future. The results of this work, and specifically the market projections developed during this analysis, were incorporated into the institution's strategic plan for 2002 - 2006 that CARANA staff has been helping to support (see section II.B.9. below).

6. Technical Assistance and Training to ODEF

Working with ODEF has presented our staff with a major challenge in that the institution's management has not always been receptive to the diagnostic work which has been completed there. At times, management has adopted a defensive position, viewing our recommendations as criticisms instead of opportunities for improvement. However in recent months we have been able to progress with them to the point where they now are more receptive to our recommendations and we believe that in 2002 this institution will be more responsive. One positive point is that ODEF (along with Hermandad de Honduras) is particularly committed to transition quickly to operate under the new FPVO law and has requested our assistance in this area.

a. Assistance in strategic planning

During the months of November and December, CARANA staff worked with the Board of Directors and Management of ODEF to assist in the preparation of its 2002 operating plan. Key strategies for 2002 and beyond reflect a reduction in the desertion rate of existing clients, a reduction in the portfolio in arrears, as well as the introduction of a new marketing strategy designed to help them capture new clients. The combination of all of the above is designed to help ODEF achieve more solid growth rates in the future.

As part of the above, our staff assisted in the preparation of a series of growth projections under different scenarios which management will be able to use to monitor actual results in 2002. Perhaps an even more important step was the recognition by management that in order to achieve their targets, the institution will have to begin to make changes in its credit procedures and policies along the lines of some of our earlier recommendations. Management also accepted the need to carry out a training program for the branch managers in order to improve their skills, particularly as it pertains to the sale of ODEF's credit products.

b. Marketing

As with Covelo, CARANA marketing specialist Luis Ludeñas also provided some assistance to ODEF in marketing. As part of this assignment, Mr. Ludeñas worked with ODEF staff to analyze the current situation in ODEF prior to making any recommendations in this area. Some of the more interesting conclusions to come from this analysis are presented below:

- ODEF, like other FPVOs in Honduras continues to suffer from a high client desertion rate. More than half of the clients serviced in the last nine years are no longer ODEF's clients.

- Over the past few years, there has been a large shift away from the village banking methodology towards solidarity and individual lending. Today, solidarity lending accounts for 71% of ODEF's clients. Our consultant believes that this shift away from village banking to solidarity lending has been accomplished without a complete understanding of the resulting implications, particularly on the work load and ability to properly supervise loans on the part of the loan officers.
- ODEF charges the same interest rate for all loans under L 50,000 regardless of the type of loan and cost of making that loan.
- As with Covelo, the productivity at the branch level varied greatly from one branch to the other as did the productivity at the loan officer level.
- Loan officers receive a fixed compensation, although there is an incentive program in place aimed at reducing loans in arrears. The incentive program does not address the capturing of new clients, the retention of existing clients, and is not directly tied to loan officer productivity.

Among the recommendations made by the consultant were:

- Introduce a new compensation system for existing loan officers with a variable component designed to increase loan officer productivity, and make it available to more loan officers in ODEF.
- Introduce a new compensation system with new loan officers (Junior Loan Officers) with a very low fixed compensation scheme and a very high variable component designed to increase loan officer productivity.
- Introduce different interest rates by loan product taking into consideration the cost of placing and administering the loans, shifting away from the single loan rate currently in use by ODEF.
- Implement a specific action plan to minimize client desertion.
- Implementation of improved tools for tracking the productivity of each branch and loan officer within each branch.
- Improved planning and reporting systems which will allow for the more efficient utilization of the loan officer's time in the field and which provides more timely information to management on the loan officer's efforts.

7. Technical Assistance and Training to FINSOL

In early 2001, FINSOL began to receive technical assistance directly from ACCION International and at USAID's request CARANA Corporation discontinued any new

activities with FINSOL. CARANA did receive permission to finalize the human resources manual defining the organizational structure, job descriptions for key positions, and a salary structure for the institution that had been promised to them previously.

For this assignment, CARANA Corporation contracted the services of a local specialist in human resources with a good understanding of compensation systems in Honduras. Working in conjunction with CARANA Chief of Party José Luis Lozano and resident advisor Elvis Alva who provided microfinance specific expertise in this assignment, we were able to present our report to FINSOL in August, and present a final approved report in September (Informe de Consultoría: “Estructura Administrativa, Manual de Puestos y Escala Salarial”, Finsol S. A. - Septiembre 2001). The English translation of the executive summary of this report is provided in annex K of this report.

With the completion of this report, CARANA staff finalized its work with FINSOL. In recent months, however, FINSOL approached CARANA staff requesting additional technical assistance which it has not been able to secure from ACCION. This request has been forwarded to USAID so that USAID can decide if CARANA should continue to work with this institution for the remaining fifteen months of the project.

8. Review of the SIEM Management Information System Within the Covelo Microfinance Network

The CARANA team recognized early in the project that there were problems with the information system that was being used by many of the FPVOs in Honduras. Consequently, it was important to bring in a specialist to review the system and provide recommendations on improving the existing system and/or suggested alternatives. This assignment was carried out in August by Mr. Hugo Velarde, a senior information systems specialist. Mr Velarde' broad experience in Peru on the application of information systems within PVO microfinance institutions, as well as with formal regulated microfinance institutions was ideal for this assignment.

Mr. Velarde completed a review of the SIEM system in five of the principal FPVOs in Honduras (Covelo, Finca, WRH, ODEF, and Hermandad de Honduras). In addition to providing an analysis and specific recommendations at the institutional level, he also provided an analysis of the system in general. The consultant's report also presented a recommendation for future actions and options in this area. Mr. Velarde made individual presentations to the management of each of the FPVOs involved in the analysis and presented a written report in September (Informe De Consultoría De Corto Plazo: “Diagnostico Del Soporte Informático Sistema SIEM Utilizado En Fundación Covelo, Finca, World Relief, ODEF Y Hermandad De Honduras” - Septiembre 2001).

Mr. Velarde's report concluded that there were many problems with the existing software. The English translation of the executive summary of this study is presented in annex L of this report. A brief summary of some of the key issues and recommendations presented in this report are detailed below:

- General System Issues
 - Not all institutions are running the software on the same operating platform nor are they all running the same software release. While the idea was to achieve some economies of scale by using the same software, installing and running different versions on different platforms has eliminated many of the efficiencies that were expected.
 - All of the FPVOs have created their own reports outside of the system given that the software does not have adequate reporting capability. Each institution's reports are different.
 - The system is not very efficient in the inputting of data, particularly data that comes in from the branches (manually). This results in information having to be processed and verified more than once.
 - Client loan payments (made through commercial banks) are not handled adequately by the system.
 - When a loan is refinanced or restructured, the system treats this as a new loan and the old loan is recorded as having been paid off. Refinanced or restructured loans are not identified as such by the system.
 - The system allows a user to manually modify the data base without a control or documentation process.
 - Software patches made by the software company responsible for the SIEM system (Soft-Corporation in Guatemala) have not been satisfactory in some cases.
- Issues with the Credit Process
 - The system does not generate timely information at the branch level where it is most needed (individual loan balances, portfolio analysis, etc.).
 - The system generates a client number by branch, and not for the whole institution. This does not allow for the tracking of individual clients at the bank level. A unique client number to be used for all transactions with the FPVO should be used. A related issue is that there is no standard for inputting the clients name making it more difficult to track individual client behavior.
 - As a result of the above, the system does not track credit history, position and behavior by individual. This is a critical management tool and a requirement if the institution is going to come under supervision and regulation by the Banking Commission.
 - The system does not track information on the client's immediate family, nor does it track information on the guarantee being offered by the client (important in the post review of loans).
 - The system does not allow for the remote review of a credit - all credit reviews and approvals are done manually.
 - The credit evaluation is not kept as part of the system (only approved credits are tracked by the system).
 - The search and analysis capability of the software is very inefficient.
 - The system does not check approved credits against a "negative list" of clients.

- Finance
 - The system does not generate adequate reports that would allow the finance area to carry out its planning functions properly. A review of existing reports generated by the system revealed some errors in the data.
- New Product Development
 - The SIEM system does not allow for the easy integration of new loan products. Each new product requires a modification which must be carried out by the software provider in Guatemala. FPVOs have complained as to the cost and lack of service.
- Accounting
 - In all institutions the consultant was able to observe important differences in the balances maintained by the SIEM system and those in the accounting system. These differences have to do with deficiencies in the SIEM system

The consultant also provided an alternative solution to the SIEM system which consists of the development of new software based on the experience in Peru. The system would correct the problems found in the SIEM system, and would allow for the transmission of information from the branches to the central office by modem thus eliminating the double entry of information that occurs now. Eventually (when technologically feasible) information would be integrated in real time from the branch office through the use of data lines.

In a follow-up visit in December, Mr. Velarde provided greater detail on the development of such an MIS. It was determined that the scope and complexity of developing this software would not be feasible under the existing Barents/CARANA task order. CARANA consultants have provided this additional information to Covelo staff in hopes that the Covelo holding company being created as part of the overall restructuring process in Covelo might consider its development in the future.

9. Institutional Strengthening and Training Efforts with Selected FPVOs in Honduras

During the six month period , CARANA Consultant William Phelps worked with CARANA staff and the managers of four FPVOs to assist them to understand and to prepare a transition plan and strategy for the new operating environment in Honduras brought about as a result of the passage of the country's new law governing FPVO operations. Among the specific actions that were carried out as part of this initiative were:

- The preparation of a PowerPoint presentation with an overview of the principal characteristics of the new law and related regulations. The presentation was used in workshops held with the Boards of Directors and managers of selected FPVOs to facilitate a clear understanding of the implications of the new law relative to the strategic objectives of each organization.

- The development of a “boiler plate” set of FPVO By-Laws (in conjunction with Covelo consultant Raul Sanchez and Covelo legal counsel) that complies with the requirements of the new FPVO law and can be used by participating FPVOs to formalize their own legal structures consistent with the specific requirements of each organization.
- Coordination of Covelo's technical assistance activities with those of the CARANA team, especially related to the strategic planning activities for 2002 and subsequent years.

In addition, CARANA staff held separate sessions with the managers and Boards of Directors of:

- Hermandad de Honduras (October 1 & 2 in San Marcos de Ocotepeque);
- ODEF (October 3 & 4 in San Pedro Sula);
- World Relief de Honduras (November 7 in Tegucigalpa); and
- FAMA (November 8 & 29 in Tegucigalpa)

These working sessions were intended to facilitate a better understanding of the new legal/regulatory environment created by the recently passed FPVO law in Honduras governing the delivery of microfinance services in Honduras. Particular attention was given to the implications of the new law relative to the specific mission and objectives of each of the organizations. The work sessions included:

- A review of the law and related regulations, and their practical implications;
- Understanding the new legal/regulatory environment relative to other initiatives to develop the sector;
- Integration of legal compliance with operational strategic planning;
- Review of options for formalization, including analysis of "pros and cons";
- Issues related to governance, financial structuring and operational priorities within the new legal/regulatory framework; and,
- Development of specific work plans for each FPVO.

The managers and directors of Hermandad de Honduras and ODEF are particularly committed to transition quickly to operate under the new FPVO law, and have agreed to incorporate compliance with the law into their strategic planning process for the Year 2002 and beyond. Both organizations requested continued assistance with their strategic planning efforts.

During the month of December, William Phelps worked jointly with resident CARANA consultant, Elvis Alva, to prepare and conduct a strategic planning workshop with the Board of Directors and staff of Hermandad de Honduras. This initiative was designed to assist them with their strategic planning efforts and the development of a work plan to establish a new FPVO consistent with the organization's strategic objectives and the requirements of the new legal-regulatory framework. This workshop produced

satisfactory progress toward formalization and specialization of the organization's microcredit operations.

10. Support to the Diploma in Microfinance Program

CARANA Corporation has been providing assistance to Covelos and the University of Honduras in the implementation of a joint program to offer a Diploma in Microfinance. In October of this year, CARANA resident staff prepared a three day work shop / course titled "Successful experiences in Microfinance in Latin America". This course presented the experiences of Banco Sol in Bolivia, FAMA in Nicaragua, and MiBanco, Caja Municipal de Piura and Caja Municipal de Arequipa in Peru.

The course covered various aspects of each institution's evolution and included such topics as the overall mission and strategy of each institution, the specific products used by each, and a discussion of some of their weaknesses or failings. Participants also received a series of handouts and additional information that they could use on their own.

In November, CARANA consultant Luis Ludeñas offered a second course for this Diploma series titled "The Marketing Mix in Microfinance Institutions With a Focus on Client Service". This three day course was offered to 42 participants and included the following topics:

- The marketing function, its relationship with the overall planning process and results;
- Competition and productivity; evaluating results, issues in measuring results and the impact on productivity;
- Market penetration and alternative strategies;
- Market research and the practical application of this research to achieve institutional objectives;
- Quality of service as a marketing strategy; and,
- Incentive plans for loan officers as a way to increase productivity, efficiency and profitability.

As with the first course, participants received additional information in the form of handouts. Both of these courses received very positive participant feedback. A separate report describing the course content, number of participants as well as participant feedback has been prepared for each course and submitted to USAID.

11. Impact of Microfinance in Honduras

This training series responds to the desire by USAID Honduras and the FPVOs to better understand the impact of its microfinance activities in Honduras. It also responds to a very high level of interest among the FPVOs in the Covelos network to better understand client behavior (desertion, satisfaction) in order to improve products and services. It is based on the USAID Washington funded AIMS- SEEP Project which was designed to better understand the processes by which microenterprise services strengthen business and improve the welfare of microentrepreneurs and their households. It also sought to

strengthen the ability of USAID and its partners to assess the results of their microenterprise development programs. Under this project, five specific survey tools were developed for use by USAID and its microfinance partners, these are:

- Impact Survey
- Exit Survey (Client Desertion)
- Use of Loan, Profits & Savings over time
- Empowerment Tool
- Client Satisfaction Tool

During the semester, CARANA sponsored two training workshops on the use of the AIMS-SEEP Impact tools. The first of these workshops was carried out in July, and focused on the Client Desertion tool (survey methodology). This particular tool was chosen first given that client desertion is a problem faced by almost all of the FPVOs in Honduras. The tool was presented in the classroom and then a survey developed as part of the workshop was tested in the field. In the months following the course, several of the institutions carried out a large number of surveys and began the tabulation process. This tool is expected to provide a better understanding on the client desertion problem. We expect each FPVO will use its findings to improve its marketing strategy to specifically address the desertion issue.

The second workshop was carried out in December, and it also consisted of a one week training program on another of the AIMS-SEEP tools - Client Satisfaction. As part of this workshop, the consultants also worked with the representatives from the FPVOs to review and understand the findings of the first survey (Client Desertion) carried out as a result of the first training program in July of 2001. The findings from the client satisfaction tool should also lead to greater client retention, and will contribute to the design of new products and services.

The level of commitment to this process has been extraordinary. All ten of the institutions participating in the training program have budgeted for this activity in 2002, and all intend to complete additional survey work by July 2002. The review of the initial results from the client desertion tool survey in December further demonstrated this commitment in that ten organizations conducted a total of 850 client interviews.

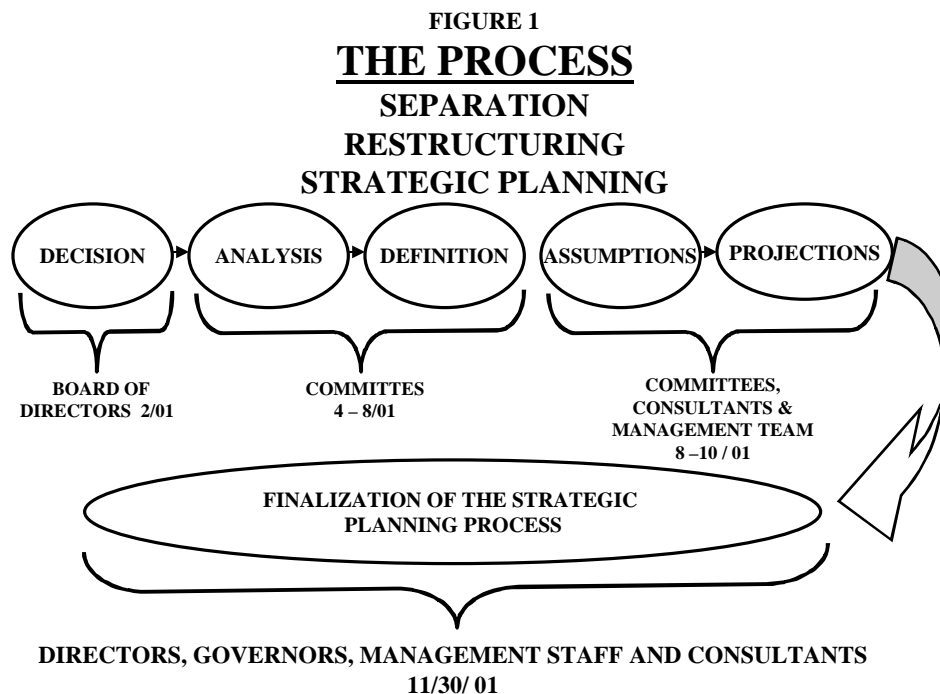
The preliminary data from these 850 interviews shows some interesting patterns in the decision by clients to leave (desert) a program. It also provides information on the period of time they were clients of the respective FPVO, their willingness to return, and their satisfaction with the program. At the same time, there were a lot of contradictory results which we believe were due to a lack of preparation and training on behalf of the individuals actually carrying out the surveys. A large part of the December training session was spent reviewing these results and problems, and in providing advice on how to better tabulate the data.

While CARANA has been providing the consultants for these training sessions as well as limited follow-up and assistance, Covelo's training staff has been doing most of the

follow-up and monitoring of the survey results. This is expected to continue in the future. It is important to note, however, that CARANA has an intern working on a "pro bono" basis in the review and re-tabulation of the of the data in order to draw better conclusions from the first survey and to provide guidance on the second survey.

C. REORGANIZATION OF FUNDACIÓN COVELO

A major activity carried out during this last semester by CARANA consultant William Phelps in conjunction with Humberto Esteve and CARANA resident staff was the support provided to the Board of Directors and Management of the Foundation in the process of conceptualizing, engineering and managing a strategy and a reorganization plan for Covelo's operations within the new legal / regulatory environment. The process began in February of this year, and has involved the organization and monthly meetings of special working committees of the Covelo Board of Directors. Phelps and Covelo consultant Raul Sanchez, supported the entire process. The consultants coordinated the efforts of the working committees, carefully prepared for and managed each of the working sessions, and documented decisions and other progress. The process itself went through six distinct phases as illustrated below, beginning with the decision to undertake the reorganization of the Foundation in February of this year, and finalizing with the decision of the Board of Directors to approve the strategic plan and financial projections prepared by the working committees and the consultants on November 30, 2001.



During this last semester, the consultants carried out or directly supervised a number of tasks in support of this reorganization process as requested by the working committees, including, but not limited to:

- The preparation of the analytical work required supporting the Covelo process of institutional specialization and transition of its retail lending operations to a regulated FPVO under the new law.
- The development of assumptions and financial projections for each of the proposed Covelo institutions in the reorganization (Covelo Holding Company, a second story lending institution servicing the needs of FPVOs in Honduras, and a retail lending FPVO operating under the new FPVO law in Honduras). Several financial scenarios were prepared under the guidelines of the special working committees.
- The preparation of documentation recording the decisions made at each of the committee meetings as well as the preparation and presentation of the final recommendations of the committees, along with related financial projections and assumptions, presented to the full Board of Directors of Covelo on November 30, 2001.

The documentation and the presentation made to the Board of Directors on November 30, 2001 resulted in the complete approval by the Board of the proposed reorganization, implementation plan and timeline for the restructuring of the Covelo Foundation. Specifics of the proposed reorganization and implementation plan include:

- A separation of the current Fundación Covelo structure into three distinct separate legal entities made up of a holding company (Fundación Covelo) and two new FPVOs operating under the new FPVO law: a separate second story wholesale lending operation; and, a retail lending operation.
- The proposed organization structure of each of the entities based on a zero based staffing basis was approved.
- It was agreed that the holding company and the two FPVOs would operate based on market pricing with no subsidies with the exception of some subsidies in providing technical assistance to other FPVOs in the Covelo network in the short run, as well as to new emerging FPVOs as approved by Covelo.
- The restructuring process will begin immediately, and will be implemented in three phases:
 - A legal and regulatory Phase, which includes a definition of the by-laws and Boards of Directors of the three institutions, to be completed by February 2002.
 - Constitution and formalization of the legal entities, including approval by the Government of Honduras (necessary for non-profits), to be started immediately and to be completed by September of 2002.
 - Operations design and implementation of the new structure, including staffing, administrative and accounting procedures, also to be initiated immediately, with a goal of finalizing this by December of 2002.

The overall target is to complete the design and transition of the process by December 2002, so as to be able to begin operating formally under the new structure by January 2003.

The detailed analyses results, assumptions, financial projections, and formal proposal for the Foundation, as well as an activity plan through the year 2005 are presented in the document titled "Supuestos y Proyecciones Financieras de: OPDF Primer Nivel, OPDF Segundo Nivel y Fundación Covelo" - Noviembre 2001, which has been made available to USAID / Honduras.

D. OTHER PROJECT ACTIVITIES

1. Credit Bureau Activities

DataCrédito Centroamericana S.A. de C.V. has continued to evolve ahead of schedule and continues to exceed expectations. It has signed contracts with approximately 90 different companies including several of the FPVOs that we work with (FINCA, FINSOL, ODEF, Covelo, World Relief, etc.). More importantly, it has signed contracts with eight of the largest commercial banking institutions in the country (Ficohsa, Bamer, Banexpo and Aval Card, BGA, Banco del País, Banco Atlántida, Banco del Occidente and Lloyds), as well as two of the savings and loans institutions (La Vivienda and La Constancia) and three cooperatives. DataCrédito has also signed contracts with about fifty commercial firms covering the full range of commercial activities in country. This solid base of customers has ensured its viability, making it the first and only functional credit bureau in Honduras.

DataCrédito has begun to offer its services to its clients and is expected to continue to grow in Honduras. At the same time it is beginning to explore other opportunities in Central America. CARANA support to this company during the last six months has been minimal and mainly oriented towards supporting its activities with the FPVOs in the Covelo network. Given that the company has now launched its products and is fully operational, we do not anticipate providing any additional support in the future.

2. Legal and Regulatory Environment

The CARANA project is also providing some limited assistance in support of the new law governing FPVO activity in Honduras which was passed in early 2001. During the current semester, CARANA staff provided assistance two activities under this initiative. The first activity consisted of an analysis of the Honduran FPVO Law & Regulations which was passed earlier in the year. This analysis was prepared at the request of USAID Honduras and was submitted to USAID in July of 2001.

The second activity involved the preparation of two manuals required under the recently passed legislation: a) an inspection manual; and, b) An external audit manual. Both of these manuals were prepared by CARANA staff and consultants and were submitted in

September of 2001 to the National Banking Commission for their review, final edit and approval.

The underlying philosophy used in the preparation of these manuals was to support the Banking Commission's mission of overseeing FPVOs guaranteeing their legitimacy, transparency, and their operational and financial security. At the same time, it is hoped that it will not result in an over regulation of microfinance activities in Honduras which would be detrimental to the expansion of this activity in the future.

The manuals were prepared in a manner which will allow the National Banking Commission to introduce a minimal set of supervision criteria in the short term, but which also defines what might be an optimal system in the long run as the sector develops and becomes more sophisticated. Our specific recommendation was that the National Banking Commission begin with this minimal set of supervision guidelines in the short run recognizing both its own as well as the FPVO's limitations. This responds not only to the state of FPVO evolution in Honduras, but to the fact that the National Banking Commission has only supervised formal financial institutions in the past and has a very limited understanding of microfinance at this time.

E. PROGRESS AGAINST PROJECT INDICATORS

1. Introduction

In early 2001, CARANA Corporation, at the request of USAID Honduras, developed a series of specific project indicators to be used to monitor progress over the three year life of project. These indicators were discussed with USAID and with the principal FPVOs receiving technical assistance under our project. Based on these discussions, a final set of indicators was presented to USAID in our Progress Report as of June 30, 2001.

In all, four types of project indicators were developed (Progress, Results, Technical Assistance and Major Activity Indicators), and these are discussed in greater detail below.

2. Progress Indicators

Progress indicators are used to monitor activity within the different components of the project, such as types of T/A interventions, training sessions, milestones accomplished. These indicators are established as part of the rolling six month work plan, and an analysis of the accomplishments during the period vs. the work plan for the period is presented in the Section F of this report - Analysis of the Work Plan vs. the Activities Undertaken.

3. Results Indicators

Results indicators are specific quantitative or measurable indicators that can be used to measure impact as a result of the technical assistance and training activities carried out

under this project. Three types of Results Indicators, each with two or three specific indicators were developed for each of the key FPVOs as indicated below:

a. Indicators measuring quality

Loan Delinquency: This is defined as the portfolio thirty days past due divided by the total loan portfolio of the institution.

Write offs: This is defined as the amount of annual loans written off divided by the total loan portfolio at the end of the year.

Desertion ratio: This is defined as the total number of clients that left the program during the year divided by the total number of clients at the end of the year.

b. Indicators measuring outreach

Total Numbers of Clients: This is the total number of clients for each of the four types of lending methodologies (Village Banking, Solidarity Lending, Individual Lending and Small Business Lending).

Total Portfolio Amounts: This is the total loan portfolio for each of the four types of lending methodologies (Village Banking, Solidarity Lending, Individual Lending and Small Business Lending).

c. Indicators measuring efficiency

Operating Efficiency: This is defined as the total annual operating costs (non interest) divided by the total loan portfolio at the end of the year.

Loan Officers to Administrative Staff: This is defined as the number of loan officers divided by the total number of administrative staff.

Self Sufficiency: CARANA has opted to use the Covelo definition of Self Sufficiency - Total Income divided by total costs.

At the time of preparation of this report (mid January 2002), the FPVOs had still not closed their accounting for the period ending December 31, 2001. Once this data is prepared and made available to CARANA, we will prepare a separate report for USAID discussing the actual vs. projected results indicators for the period, along with an analysis of any variances that may occur.

An analysis of preliminary data made available to us reveals that for the most part, these institutions are meeting their targets. The exception to this is FINCA, which due to problems found under the previous administration, has had to undergo a complete reorganization and a change in management. This has led to a decrease in staff, and a

decrease in the number of clients in loans as part of the in house cleaning effort carried out in mid 2001.

4. Technical Assistance Indicators

In our report to USAID on the development of project indicators, CARANA had proposed that we also measure the progress of these FPVOs as they absorb the technical assistance and training provided to them. Our proposal was to measure this in two stages: 1) The decision by an FPVO to test our recommendations in a pilot program at the branch level in one or two locations (Pilot Program); and, 2) The decision by an FPVO to implement the program across the complete institution ("Roll-out"). The specific targets that we are proposing are shown below.

	6/2001	12/2001	6/2002	12/2002
Decision to Adopt a Pilot Program	2	4	5	5
Decision to Implement a Roll-Out of the Pilot Program	0	2	4	5

As indicated earlier in this report, as of December 31, 2001 all five of the principal FPVO's (FINCA, World Relief, Covelo, HDH, ODEF) had made the decision to adopt a pilot program based on our recommendations. Two of these institutions (FINCA and HDH) have progressed far along on the implementation plan to have made the decision to make final modifications to revised formats and procedures and to implement across the institution in 2002. These results slightly exceeded our expectations for the period ending December 31, 2001.

5. Major Activity Indicators

In addition to the technical assistance and training provided to FPVOs under our project, there are two major activities that we are involved in that provide support to the overall microfinance activity in Honduras. A discussion of these is provided below.

a. The new law governing financial PVOs (FPVOs)

Targets in this area were developed earlier in the year and are as shown below:

- September 2001:
 - "Reglamento" as well as the Supervision Manual and Audit Manual drafted and presented for approval.

- December 2001:
 - Approval of the "Reglamento" and Manuals.
 - The Law becomes functional.
 - Preliminary decision by at least 2 FPVOs to come under the law³
 - Specific T/A to FPVOs to support the transformation
- June 2002:
 - Two FPVOs formally operating under the law
 - Decision by three additional FPVOs to operate under the law.
 - Specific T/A to FPVOs to support the transformation
- December 2002:
 - Four FPVOs formally operating under the law
- March 2003:
 - Five FPVOs formally operating under the law

As reported in section D.2 of this report, CARANA was responsible for the drafting of the Supervision and Audit manuals under the law, and these were completed on time and presented to the Banking Commission as well as to the FPVOs in September as planned. CARANA staff members also contributed in the preparation of the "Reglamento", although the principal responsibility for the preparation of the "Reglamento" was Covelo's. This also was completed and submitted to the Banking Commission on time.

The December 2001 targets included the approval of the "Reglamento" and Manuals by the Banking Commission, the next step before the FPVO Law can become functional. This step has not been completed by the Banking Commission as of this time, and indicates that the National Banking Commission may require additional assistance if it is to adequately carry out its responsibilities under the new law.

However, as called for under our December 2001 targets, CARANA has begun the process of providing technical assistance to FPVOs to help them in the transformation process (See Section II.B.9 - Institutional Strengthening and Training Efforts with Selected FPVOs in Honduras). Furthermore, as reported in that section, we are now aware of at least three institutions (Covelo, HDH and ODEF) that are formally committed to making the transition to a regulated FPVO under the law, and that are working to do so in 2002. Others have expressed that they will eventually choose to become regulated institutions as well, but have not set in motion a specific process to accomplish this at this time.

b. Support in establishing a credit bureau in Honduras

As reported in section II.D.1, this activity under our project is well ahead of schedule. While the targets for this activity specified that the Credit Bureau was expected to start

³ Either the current FPVO law, or existing banking or "financiera" laws governing formal financial institutions.

up in June of 2002 and be fully operational by December of 2002, DataCrédito has already completed the start-up phase, and will be fully operational in the first quarter of 2002.

F. ANALYSIS OF THE WORK PLAN VS THE ACTIVITIES UNDERTAKEN

1. Specific Technical Assistance to Tier I and II FPVOs

All of the activities programmed for this semester were carried out successfully and all of the objectives were either met or exceeded. All of the activities highlighted in our action plan were carried out with respect to Finca, ODEF, Hermandad de Honduras, World Relief and FINSOL, and as detailed in section II.B of this report, we are very pleased with the progress made at each of these institutions. The only exception to this pattern was ODEF, where we continued to meet resistance from management in accepting our recommendations. However, as reported in section II.B.6, in recent months we have made significant progress with them and we believe that in 2002 this institution will be more responsive.

Included in the technical assistance program for this semester was the support that we had programmed for FPVOs on institutional strengthening and eventual regulation of the FPVOs under the new law. This activity was stepped up during the latter part of the semester given the approval of the new FPVO law on one side, and the request by several FPVOs for assistance in their planning activities for 2002 and beyond, including a greater understanding of the requirements of the new law on the FPVOs. The major beneficiaries of this activity (in addition to Covelo which is reported separately below) have been Hermandad de Honduras, ODEF, World Relief and FAMA.

2. Assistance to Covelo's retail and wholesale operations

a. Assistance to Covelo's retail operation

In this area (see section II.B.4), CARANA was able to progress rather quickly after a slow start earlier in the year. Our work for Covelo's retail operations included assistance in credit methodology (simplification of procedures and formats), the design of a new incentive program for loan officers, and assistance in marketing. Our objectives for this semester with Covelo's retail operations were achieved.

b. Assistance to Covelo's reorganization process

As reported in section II.C, CARANA staff was heavily involved with Covelo's Board of Directors, Management and key staff in carrying out this activity. The decision by the Board of Directors to approve the strategic plan and financial plans prepared by the working committees which would bring about the separation of Covelo's microcredit retail operations from its wholesale and planning (holding company) activities was a major step which was achieved much sooner than anyone had anticipated early in 2001. We strongly believe that our efforts in this area, which provided continuity, quality

control and guidance was essential in the early culmination of the feasibility and approval process.

3. Training Programs

As stated in the introduction of section II.B (Technical assistance and training activities), the bulk of our training activities in this semester shifted from more general training programs offered to a broad audience to specific institutional training sessions complementing our technical assistance activities. This has been very successful, and we believe that the recipient institutions have benefited greatly from this.

While most of the training has been institution specific, we have continued to support Covelo in its general training activities by providing the trainers for the Measuring Impact - AIMS Impact Methodology and Tools workshops as well as the supplying of two trainers / instructors for the Diploma in Microfinance program being implemented by Covelo and the University of Honduras. During the semester, CARANA carried out two training programs in the AIMS Impact Methodology and Tools (only one had been programmed) and these have been received very positively by the participating FPVOs. CARANA's support for the Diploma in Microfinance program was not anticipated in the work plan, but at Covelo's request, we were able to provide the two trainers for two separate sessions (successful microfinance experiences in Latin America, and marketing in microfinance institutions) as reported in section II.B.10.

4. Other Initiatives

The work plan also anticipated assistance to specific institutions in marketing, as well as more general support in the way of an analysis of the current MIS system used by key FPVOs in Honduras, and our assistance in support of the new law governing FPVOs in Honduras.

a. Marketing Assistance

As reported in the respective sections in II.B, CARANA provided institutional specific technical assistance in marketing to Covelo, Hermandad de Honduras and ODEF. The focus of this activity has been in helping these institutions overcome client desertion problems, while attracting new clients in order to achieve greater growth while lowering loan delinquency rates.

b. MIS analysis and recommendations

As reported in section II.B.8, the analysis of SIEM MIS system being used by key FPVOs in Honduras was undertaken. This analysis has revealed serious problems with this system which were highlighted in the report. CARANA is currently working with Covelo and the other FPVOs to help define what the best course of action would be for the long run.

c. Support to the implementation of the law governing FPVOs

CARANA's support in this area was limited to the preparation of the audit and supervision manuals for the Banking Commission, and a limited review of the "reglamento" for this law which was prepared by Covelo. Both of these activities were completed on time.

5. Analysis of Level of Effort - Projected vs. Actual

During the period, CARANA did exceed the programmed level of effort for short term consultants by a total of 49 days (resident staff days did not vary from what was budgeted). The detail of budgeted days vs. actual days is contained in the table at the end of this section, however, the major reasons for exceeding the original budget include:

- An extra six days of technical assistance provided to FINCA by Henry Cardona (extension of one of his assignments);
- An extra ten days of time dedicated to the human resources initiative at FINSOL;
- An extra course on the Measuring Impact - EPI-INFO series was added in December;
- Support to the Covelo University of Honduras Diploma program which was not initially programmed; and
- An extra two weeks of assistance in the MIS analysis work carried out, which included an extra trip by the consultants in December to review alternatives to improve the MIS issues faced by all of the FPVOs.

Part of the above was offset by a savings of about ten days in the institutional strengthening work being carried out with all of the FPVOs. In all cases, the decision to increase the level of effort was made after reviewing the work of the consultant(s), the additional requirements at the time, and measuring the cost benefit of the additional days vs. the impact on the remaining budget.

TECHNICAL ASSISTANCE PROGRAM - 7/1/01 TO 12/31/01
PROGRAMMED VS. ACTUAL LEVEL OF EFFORT

<u>ACTIVITY</u>	BUDGET		
	<u>STTA</u>	<u>ACTUAL</u>	<u>BALANCE</u>
SPECIFIC T/A - FPVOs			
Assistance to Finca	58	64	-6
Assistance to ODEF			
Assistance to Hermandad			
Assistance to World Relief			
Assistance to FINSOL	22	32	-10
Assistance to FPVO Boards /			
Institutional Strengthening	30	30	0
Assistance to Covelo			
Assistance to Covelo (1st floor)			
Assistance in Covelo's Institutional			
Restructuring Effort	30	20	10
Training Programs			
Finca	2	2	0
ODEF			
Hermandad de Honduras			
World Relief			
Covelo			
FINSOL	2	2	0
Measuring Impact EPI-INFO	40	59	-19
Other Initiatives			
Marketing - New Clients / Products	24	30	-6
MIS Analysis / Recommendations	24	40	-16
Audit & Supervision Manuals	24	26	-2
Covelo Diploma Program	0	6	-6
Total Level of Effort	256	311	-49

G. FINANCIAL DATA

1. Costs Incurred Through December 31, 2001

Based on our preliminary estimates of December expenses we have incurred a total of \$1,346,541 in labor and expenses out of a total of \$2,347,575, or 57% of the project budget total. With regards to the total level of effort, we have utilized a total of 49%, or 1,502 man days out of a total of 3,059 days budgeted. Projected expenditures for the semester ending December 31, 2001 were \$470,000 vs. actual expenditures of \$517,000.

The financial statement below indicates that overall CARANA is incurring costs against the budget as expected. However, there are two areas of concern which will need to be addressed in the near future by CARANA through KPMG Barnets to USAID. The first is a deficit in the number of days and dollars budgeted for the Financial Analyst Level 3 category, which is a result of the additional seminar on Measuring Impact which we carried out in December of 2001 which had not been anticipated in our work plan for the period⁴. The second area of concern is the remaining balance on Other Direct Costs (\$222,000), which given the increased activity and costs since mid 2001, will need to be increased. A more in depth analysis of the budget and estimated projections is presented in greater detail in the section on Projected Costs through March 31, 2003 below.

Financial Statement as of 12/31/01
U.S. Dollars

	<u>Budget</u>	<u>To Date</u>	<u>Balance</u>	<u>Balance %</u>
CB1	567,831	299,352	268,479	47%
FA1	230,500	128,195	102,306	44%
FA3	14,832	19,794	-4,962	-33%
TCN Res Advisor	486,017	202,830	283,188	58%
CCN Sec / Admin	27,258	3,245	24,013	88%
TCN Short Term	<u>321,809</u>	<u>216,105</u>	<u>105,704</u>	<u>33%</u>
	1,648,247	869,520	778,727	47%
ODCs	699,328	477,021	222,307	32%
Total	2,347,575	1,346,541	1,001,034	43%

Level of Effort - Days

	<u>Budget</u>	<u>To Date</u> <u>12/31/01</u>	<u>Balance</u>	<u>Balance %</u>
CB1	443	237	206	47%
FA1	180	102	79	44%
FA3	24	32	-8	-33%
TCN Res Advisor	1,101	474	627	57%
CCN Sec / Admin	445	65	380	85%
TCN Short Term	<u>866</u>	<u>592</u>	<u>274</u>	<u>32%</u>
Total	3,059	1,502	1,558	51%

⁴ The problem is not so much the overall budget itself since we have 49% of the total work days unutilized at this time, but rather due to the fact that at the last minute we had to substitute one of the trainers (a TCN short term advisor) for another trainer that was a Financial Analyst Level 3.

2. Projected Costs through March 31, 2003

The table below shows the level of effort that we expect to incur over the final fifteen month period under this task order. It is based on the work plan which is presented in section III of this report.

Level Of Effort Analysis vs. Budget
(Man Days)

<u>Labor Categories</u>	<u>Beginning to 12/31/01</u>	<u>January 02 March 03</u>	<u>Total</u>	<u>Budget</u>	<u>Balance</u>
Commercial Banker 1	237	60	297	443	146.0
Financial Analyst 1	102	75	177	180	3.5
Financial Analyst 3	32	0	32	24	-8.0
TCN/CCN Personnel	<u>1,131</u>	<u>1,270</u>	<u>2,401</u>	<u>2,412</u>	<u>11.0</u>
Total	1,502	1,405	2,907	3,059	152.5

The above shows that based on our current projections, we will have a total of 152.5 days remaining at the end of the project of which almost all are Commercial Banker Level I days. The 146 days of the Commercial Banker Level I category have a value of approximately \$190,000.

The financial analysis shown in the previous section, showed that out of a total of \$699,328 budgeted for Other Direct Costs - ODCs (Allowances, Travel, Equipment, Other Direct Costs and NICRA G&A), we had incurred a total of \$477,021 through December 31, 2001. This leaves a remaining budget of \$222,307 for the final fifteen months of the project, or approximately \$14,800 per month. During the first six months of 2001, CARANA was incurring ODCs at a rate of \$15,500 per month, however during the period between July and December 2001, this figure jumped to \$33,000 per month.

The major reasons for the increase in the rate of spending on ODCs was due to the increase in level of activity under the project - a 63% increase in the level of effort. Some of the increase in ODCs was due to non-recurring items (new equipment for new office, costs associated with some of the training sessions, costs associated with the Covelo restructuring and the Banking Commission initiatives). However, we do anticipate an increase in the level of monthly ODC spending to about \$25,000 from the \$15,000 experienced earlier in the year due to an increase in recurring costs such as the new office, increased personnel (which leads to increased allowances and support costs such as communications, office expenses, transportation, etc.). This translates into a shortfall of about \$153,000 in the current ODC budget, or an overage of 22% of the current ODC budget. As a result CARANA will request a budget modification in the near future to re-align budget items within the existing budget total reflecting actual and projected rates of spending in labor and ODCs.

3. Quarterly Expenditures Through March 31, 2002

Based on projected levels of effort and ODCs, CARANA estimates that quarterly expenditures will average \$200,000 for the remaining five quarters of the project, or \$67,000 per month. Of the quarterly amount, we believe \$75,000 (37.5%) will be in ODCs and \$125,000 (62.5%) will be in labor charges. This rate of spending and this relationship between labor and ODC expenditures is consistent with the rates of spending during the last two months of 2001.

Projected cumulative expenditures by quarter are shown below:

3/31/02:	\$1,545,000
6/30/02:	1,745,000
9/30/02:	1,945,000
12/31/02:	2,145,000
3/31/03:	\$2,345,000

Total Project Budget: \$2,347,575

H. KEY ISSUES FACING THE PROJECT AT THIS TIME

The project is not facing any major issues or threats at this time. At this time we are achieving or exceeding our targets and objectives against the work plans as detailed in section II.F. of this report. Our relationships with Covelo and the FPVOs receiving technical assistance has been very positive and we face a high demand from these institutions for the types of technical assistance and training that we have been offering and continue to offer through to the end of the project.

1. Activities Not Being Addressed Under This Project

It is important to note that there are some needs which are currently not being met by the project, mostly due to budget and time limitations. These are discussed briefly below.

- a. Training and support to the National Banking Commission on the implementation of the new law governing FPVOs in Honduras

Under this microfinance support project, CARANA's support to the National Banking Commission in its efforts to implement the new law governing microfinance institutions has been limited to the drafting of the audit and inspection manuals called for under that law. This task was completed in August of 2001. However, there is no doubt that the National Banking Commission will require assistance in establishing the supervisory body within the Superintendent of Banking as well as for the training of its staff in the implementation of a streamlined and efficient supervision process. Support for the FPVOs in this area would center on the establishment of a real internal control function through technical assistance and training designed to meet the requirements of the new law.

Experience from other countries has shown that the regulatory body supervising microfinance institutions needs to understand microfinance lending, and particularly the differences between microfinance lending and the activities carried out by traditional commercial banks and "financieras". This understanding is necessary so that the National Banking Commission can carry out its supervisory role efficiently while at the same time stimulating healthy growth in the sector. Not assisting the National Banking Commission in Honduras at a time when they are requesting this assistance and are very receptive could have adverse effects on the sector (i.e., over regulation, excessive paperwork and bureaucracy, inefficient supervision, etc.).

b. The need to develop a better MIS solution for FPVOs in Honduras

there are critical problems with the MIS system currently being used by the key microfinance institutions in the Covelo network. The problems with the current system affect the operations of these microfinance institutions as well as their ability to effectively monitor trends in their loan portfolios. The existing MIS will also make it difficult for the FPVOs and the Banking Commission to work together to efficiently carry out the supervision of these FPVOs as required under the new law.

CARANA's consultants believe that the development of an MIS system would contribute enormously in consolidating the technical assistance at the FPVO level. An MIS system that corrects the problems of the current system would facilitate the implementation of many of the recommendations being made by CARANA's staff (delegation of authority, streamlined credit procedures, improved decision making, better risk management, better management reporting, better portfolio analysis, variable incentives for loan officers, etc.).

An MIS solution should correct the limitation discussed in our report and will require that some organization be willing to invest the resources to develop such a system and to maintain it over time. CARANA staff is currently discussing the problem with Covelo's management with the hope that Covelo's management will take an active role in developing a long term MIS solution in Honduras.

c. Additional assistance to Tier III FPVOs and other FPVOs that have not received intensive technical assistance under this project

As explained in the initial work plan submitted in June of 2000, CARANA and Covelo made a strategic decision to focus on several key FPVOs within the Covelo network (Tier I and Tier II institutions). These Tier III FPVOs represent a large number of microfinance clients in Honduras (more than 25,000) making them an important segment in the microfinance community (three of them have over 5,000 clients each). The law governing FPVOs will also apply to these institutions, and as a result, we believe that many of them will require some technical assistance in the future in order to successfully transition to regulated FPVOs in the future.

FINSOL, which is an institution that received assistance from CARANA in the initial phases of the project, stopped receiving technical assistance from CARANA when it began to receive assistance directly from ACCION International. However, this assistance has not met their expectations and they are again asking for assistance under the microfinance support project in a variety of areas. FINSOL has received valuable assistance from USAID in the past and became the first regulated microfinance institution in Honduras. Today it faces new challenges and it is experiencing new difficulties which should be addressed soon.

d. Follow-up assistance to Covelo reorganization

During the last year, CARANA has provided valuable technical assistance to Covelo's management and Board of Directors regarding the restructuring of the Covelo Foundation. The result of this has been a decision by the Board of Directors to restructure the organization and will result in the legal separation of the retail and wholesale credit operations much sooner than anticipated. This restructuring will allow Covelo to comply with the new law governing FPVOs and will also provide it with the flexibility to carry out new activities supporting the microfinance sector in the future. CARANA's involvement in the reorganization process was finalized with the Board's approval of the strategy and financial projections in November of 2001. Covelo has requested additional assistance in this area, however due to budget restrictions, we have not scheduled any assistance for this initiative in the remaining fifteen months of the project.

III. WORK PLAN FOR THE PERIOD FROM JANUARY 2002 THROUGH MARCH 2003

A. INTRODUCTION

The work plan presented in this section covers the fifteen month period beginning on January 1, 2002 to the end of the project on March 31, 2003. CARANA's focus during this period is to consolidate technical assistance and training at the FPVO level. Technical assistance will mostly be provided to Tier I and Tier II institutions with whom we have made solid gains up until this point in the project. At the same time, other forms of technical assistance provided earlier in the project, such as the assistance provided to Covelo's management and Board of Directors on restructuring issues or the assistance provide to the National Banking Commission on the implementation of the new law, have been or are being phased out.

Most of the technical assistance and training activities will be implemented by our long term residents and a small group of short term consultants, all of whom have already worked on the project and are familiar with the needs of the Honduran FPVOs that they have been working with. The work plan for each institution has been discussed and approved by its management. Interventions for this next fifteen month period are focused on particular areas of concern within selected FPVOs that have been previously identified and for the most part are a continuation of previous support.

B. INSTITUTIONAL WORK PLANS

1. ODEF

The work plan for ODEF calls for assistance in three main areas, in addition to some selected follow-up assistance in areas that were addressed during the previous year. The three areas of assistance are:

- Institutional strengthening and support in the transition to a regulated FPVO
 - Assistance in this area will be provided to management and the Board of Directors. This reflects their commitment to be one of the first FPVOs to transition to a regulated FPVO under the new law.
- Market analysis and assistance with the expansion into new areas
 - This will follow up on earlier successes in La Ceiba and La Entrada
- Decentralization of the credit approval process
 - As with most other FPVOs, ODEF's credit approval procedures are cumbersome and highly centralized. We will be working with ODEF on the credit approval process and particularly on providing greater autonomy at the branch level.

Follow up assistance will also be provided in some of the areas highlighted in our report in section II.B.6.b.

2. Hermandad de Honduras

Assistance to Hermandad de Honduras is focused on the areas below:

- Institutional strengthening and support in the transition to a regulated FPVO
 - Assistance in this area will be provided to management and the Board of Directors. As with the case in ODEF, Hermandad has made a commitment to be one of the first FPVOs to transition to a regulated FPVO under the new law.
- Marketing assistance - Developing greater client loyalty and reducing client desertion rates
 - Many of the FPVOs are crippled in their attempts to grow their loan portfolios because they are suffering from very high client desertion rates. This work will compliment the work carried out in 2001 with HDH in the marketing area.
- Human resources - Development of personnel manuals on staffing, job description and salary structures
 - HDH's weaknesses in this area are not unique, and we will also be providing this type of support to other FPVOs. This work will be based on the work which was carried out with FINSOL in 2001, and will be carried out by the same local consultant. This also supports the technical assistance provided to HDH by CARANA in 2001.

Additional technical assistance will be provided by our resident staff to follow up specifically on the above interventions, or as a follow-up to assistance provided previously under the project.

3. Covelo's Retail Operations

The work plan for Covelo's retail operations is limited to two major areas in addition to some follow-up assistance on previous themes.

- Marketing - Development of new financial products
 - This reflects a desire by the institution to develop new products aimed at improving client satisfaction, minimizing desertion rates, and targeting new clients. This work also compliments the work in the marketing area carried out with Covelo in the second semester of 2001.
- Strengthening the Internal Audit Function - Design of policies and procedures, manuals, annual audit work plans, etc.
 - This is an area of weakness identified during the diagnostic phase of the project. The overall objective is to allow for greater decentralization of the decision making process on one hand, while allowing for greater control and information on the other.

Our resident advisors will also be providing some follow-up assistance to Covelo in areas that were addressed earlier during the project.

4. World Relief of Honduras

World Relief of Honduras, along with Finca, have been the most responsive and receptive FPVOs under our technical assistance program. Consequently, the work plan for this institution for the remaining fifteen months is one of the most ambitious.

- Institutional strengthening and support in the transition to a regulated FPVO
 - Assistance in this area will be provided to management and the Board of Directors and reflects their desire to transition to a fully regulated FPVO in 2003.
- Marketing assistance - Developing greater client loyalty and reducing client desertion rates
 - The work in this area will support the organization's growth by helping to retain existing clients while identifying new ones.
- Human resources - Development of personnel manuals on staffing, job description and salary structures
 - Work for World Relief in this area will parallel that already undertaken with Finsol in 2001 and which is also going to be carried out with HDH during this fifteen month period.
- Strengthening the Internal Audit Function - Design of policies and procedures, manuals, annual audit work plans, etc.
 - As with Covelo, this is an area of weakness identified during the diagnostic phase of the project. This work is critical for World Relief, particularly given the aggressive growth rates projected for this year in which it expects to exceed 27,000 clients.

Our resident staff will also be providing follow up assistance in the above areas or in areas addressed earlier during the project.

5. FINCA

As stated earlier in our report, FINCA has been the most responsive of all of the FPVOs in implementing our recommendations. Our focus with Finca will be on supporting earlier gains in addition to the three main areas discussed below.

- Institutional strengthening and support in the transition to a regulated FPVO
 - Assistance in this area will be provided to management and the Board of Directors and reflects their desire to transition to a fully regulated FPVO in 2003.

- Strengthening the Internal Audit Function - Design of policies and procedures, manuals, annual audit work plans, etc.
 - As with Covelo and World Relief, this is an area of weakness identified during the diagnostic phase of the project.
- Marketing assistance - Developing greater client loyalty and reducing client desertion rates - Design of new financial products
 - The work in this area will support the organization's growth by helping to retain existing clients while identifying and targeting new clients.

Our resident staff will provide support in the implementation of the above as well as in the follow-up on assistance provided earlier under the project.

6. FAMA

FAMA is one of two Tier III institutions that we will be providing limited assistance to in the next fifteen months. Assistance to FAMA will be limited to two areas.

- Transition to a fully regulated FPVO
 - Support to the Board of Directors and Management in the transition to a fully regulate FPVO.
- Marketing Support
 - Analysis of the operations of one office with a focus on client loyalty and desertion issues as well as other credit operations issues.

7. FUNED

FUNED represents the second Tier III FPVO that we will be providing limited assistance to during the coming fifteen months. Assistance to FUNED will be limited to an analysis of the marketing function with a focus on client loyalty and client desertion issues.

C. PROJECTED LEVEL OF EFFORT

The table below details the level of effort over the next fifteen months for U.S. Consultants, TCN Consultants and the two resident staff members. It is important to note, however, that for the bulk of the work to be carried out by the short term consultants will be carried out during the next twelve months, leaving the last three months of the project for and follow-up assistance by our resident staff to finalize and pending items.

TECHNICAL ASSISTANCE PROGRAM - 1/1/02 TO 3/31/03
PROGRAMMED LEVEL OF EFFORT

<u>ACTIVITY</u>	<u>S.T. U.S, TA Days</u>	<u>S.T. TCN TA Days</u>	<u>Resident COP Days</u>	<u>Resident #2 Days</u>
ODEF				
Transformation to a Regulated FPVO	12		5	
Marketing - Market studies		24	10	
Support in Decentralizing the decision process		24		10
Resident Staff support on above and follow-up			15	30
HERMANDAD DE HONDURAS				
Transformation to a Regulated FPVO	12		5	
Marketing - Client loyalty and desertion issues		21		10
Human Resources - Organization manuals, policies, etc.		20	10	
Resident Staff support on above and follow-up			15	30
COVELO RETAIL OPERATIONS				
Marketing - New Products		24	10	
Internal Audit - Policies, manuals, work plans, etc.		24	5	10
Resident Staff support on above and follow-up			15	30
WORLD RELIEF OF HONDURAS				
Transformation to a Regulated FPVO	12		5	
Marketing - Client loyalty and desertion issues		24		10
Human Resources - Organization manuals, policies, etc.			20	20
Internal Audit - Policies, manuals, work plans, etc.		24		10
Resident Staff support on above and follow-up			15	30

Continued on next page

TECHNICAL ASSISTANCE PROGRAM - 1/1/02 TO 3/31/03
PROGRAMMED LEVEL OF EFFORT - CONTINUED

FINCA

Transformation to a Regulated FPVO	12		5	
Internal Audit - Policies, manuals, work plans, etc.		24	10	
Marketing - Client loyalty and new financial products		24		10
Resident Staff support on above and follow-up			15	30

FAMA

Transformation to a Regulated FPVO	12		5	
Marketing - Client loyalty and branch analysis		18	10	20

FUNED

Marketing - Client loyalty and desertion issues		24	5	10
Project Mgmt, Administration	<u>75</u>		<u>145</u>	<u>65</u>
Total Level of Effort	135	275	325	325

In addition to the above, a total of 345 secretarial days (CCN) are budgtd.

IV. ANNEXES

A. ANNEX A - LIST OF MAJOR DOCUMENTS AND REPORTS FOR THE SEMESTER ENDING DECEMBER 31, 2001

Honduran FPVO Law & Regulations: Analysis And Observations - July 2001

Informe De Evento De Capacitación: “Curso de Evaluación de Impacto y Satisfacción de Clientes en Instituciones y Programas de Microfinanzas” - Julio 2001

Informe Del Evento De Capacitación: “Taller Sobre Control Interno En Finca Honduras” - Agosto 2001

Informe De La Consultoría Realizada En Finca Honduras - Agosto 2001

Progress Report on Covelo Restructuring Effort - August 2001

Informe De Consultoría: Manual De Inspección Y Auditoria Externa Para Organizaciones Privadas De Desarrollo - Agosto 2001

Informe de Consultoría: “Estructura Administrativa, Manual de Puestos y Escala Salarial”, Finsol S. A. - Septiembre 2001

Informe De Consultoría De Corto Plazo: “Diagnostico Del Soporte Informático Sistema SIEM Utilizado En Fundación Covelo, Finca, World Relief, ODEF Y Hermandad De Honduras” - Septiembre 2001

Informe De La Consultoría De Marketing Realizada En La Fundación José María Covelo - Septiembre 2001

Informe De La Consultoría De Marketing Realizada En Organización De Desarrollo Empresarial Femenino; ODEF - Octubre 2001

Informe De La Consultoría Realizada En Finca Honduras - Octubre Del 2001

Informe De Capacitación En Finca: “Herramientas Para Mejorar Análisis De Micro Negocios” - Octubre Del 2001

“Experiencias Exitosas De Microfinanzas En Latinoamérica” Módulo I: Diplomado en Microfinanzas - Noviembre 2001

"Mezcla De Mercadeo En Entidades De Microfinanzas; Servicio Al Cliente” Módulo II: Diplomado en Microfinanzas - Diciembre del 2001

Progress Report on Covelo Restructuring Effort and Institutional Strengthening Initiative with Selected FPVOs in Honduras - December 2001

Informe De Consultoría Realizada en World Relief de Honduras de Julio - Diciembre Del 2001 - Diciembre 2001

Informe De Consultoría Realizada en la Fundación Covelo de Julio a Diciembre del 2001 - Diciembre 2001

Informe De Consultoría Realizada en Hermandad de Honduras de Julio a Diciembre del 2001 - Diciembre 2001

Informe De Consultoría Realizada en la Organización de Desarrollo Empresarial Femenino (ODEF) de Julio a Diciembre 2001 - Diciembre 2001

Informe De Evento De Capacitación: “Curso De Evaluación de Impacto y Satisfacción de Clientes en Instituciones y Programas de Microfinanzas” - Diciembre 2001

B. ANNEX B - EXECUTIVE SUMMARY: TRAINING SEMINAR “WORKSHOP ON INTERNAL CONTROLS IN FINCA-HONDURAS”

Tegucigalpa, August 3, 2001

Consultants: Henry Cardona, José Luis Lozano

1. Introduction

The seminar took place on August 3, 2001 and involved the participation of 35 FINCA employees from the central and regional offices. The seminar was held in the offices of CADER in Tegucigalpa.

The themes and materials presented in the seminar were based on FINCA's experiences. The seminar itself was part of a broader consulting effort in the areas of improving internal controls within this institution.

The facilitator, Henry Cardona, who was also the consultant in charge of the overall consulting assignment is a professional with extensive experience and knowledge in microfinance and the risks involved in this type of lending. The consultant has already undertaken several assignments in Honduras and as a result has a good understanding of microfinance institutions in Honduras.

The topics included in the agenda, all of vital importance for the strengthening of this organization, were developed jointly with the management of the institution and the seminar participants. The seminar featured strong participation by the attendees who not only asked in depth questions regarding the topics and cases presented, but who also made valuable suggestions for improving the internal control procedures within the organization..

A list of the major topics covered in the course are presented below:

- What is understood by internal control
- Who is responsible for implementing internal controls
- What are internal controls
- Internal control vs. risk
- Why is it necessary to strengthen the internal control function in FINCA
- Functions and responsibilities in minimizing risk
- How to minimize risks
- Common risks associated with microfinance institutions
- How to develop effective risk actions
- Developing efficient risk minimization procedures
- Internal control policies
- Control and the internal audit function

The methodology used in developing and delivering the workshop stimulated a great amount of feedback and participation which we believe greatly enhanced the understanding and acceptance of the topics at all levels of the organization. This process should greatly facilitate the implementation of the changes in the internal control procedures that are being implemented in FINCA as a result of this consulting assignment.

C. ANNEX C - EXECUTIVE SUMMARY: REPORT ON THE CONSULTING ASSIGNMENT IN FINCA IN AUGUST OF 2001

Consultant: Henry Cardona

1. Introduction

FINCA – Honduras is in the middle of an in-depth reorganization and adjustment period which has been costly and which has resulted in a high level of employee turnover. As a result, it will be difficult for FINCA's management to show short term improvement in the quality of their portfolio, employee morale, and their level of commitment and loyalty to the institution. However, there is no doubt that the reorganization was necessary and that the institution will emerge much stronger from this in the medium to long term.

FINCA's management does expect to see improvements in both the levels and quality of the loan portfolio in this second semester of 2001. In part this improvement is expected because the implementation of a "Stabilization Plan" which began in April, should be completed by August of this year.

On this second technical assistance intervention by CARANA in 2001 our consultant conducted a follow up on the recommendations made as a result of the first assignment. This was followed by additional and complementary recommendations made to improve the credit process and internal control procedures. The consultant also recommended the establishment of a budget division in the central office which would establish budgets and control procedures and which would also establish profit center by area of responsibility. We believe that this process of introducing profit centers at the branch and regional level will improve the internal control and management functions and will eventually lead to more profitable operations.

2. Recommendations

a. Credit Portfolio:

- Management should carefully monitor the loan portfolio to avoid any further deterioration in the short term. The aggressive tracking and pursuit of past due loans within the first thirty days has shown very good results, however overall indicators still show an increase in past due loans greater than 30 days.
- The regional offices that requires greater attention are those in Copan and Comayagua due to their negative indicators in the village banking portfolio which makes up the majority of the loans of these branches. Their indicators are the highest in FINCA, in part due to verified cases of fraud.
- The of village banking portfolio in Tegucigalpa, Choluteca, and San Pedro Sula show a healthy tendency, but controls must be maintained due to the past volatility in these markets.

- The individual lending portfolio still suffers from elevated default rates. The slow recovery of loans and the continued deterioration of this portfolio will continue to have a negative affect in the future. FINCA must undertake legal action to collect these loans as it is the only way it will recover them.
- A 2.5 million Lempiras write off is currently being debated by management, and if approved will result in a substantial reduction in the 30+ days past due rate for loans. A strong monitoring (internal control) activity complimented by the necessary legal actions on collections when necessary and an improved credit analysis process to avoid bad loans to begin with will yield the positive results that management is seeking.

b. Internal Control

- Review, adjust, disseminate, and put into practice the internal control procedures presented in the manual prepared after the previous consulting assignment.
- To reduce portfolio risk in the future, FINCA must develop a training program for loan officers to improve their credit analysis skills and which will allow the loan officer to make better decisions in the loan analysis process.
- As a complement to the previous recommendation, the implementation of an index card system like the one proposed in this document, that clearly identifies the social and economic profile of the applicant, will contribute to improved client information. It is also useful because it gives the loan officer vital information on the applicants credit history with FINCA which will contribute to a better loan review.
- All applicants should be reviewed against the client data base, specifically the "negative list" before accepting their participation in any of FINCA's programs.
- Management must insist on the adherence to all credit policies and procedures by its employees. If necessary, management should be ready to apply the sanctions detailed in the labor agreements with its employees. Management must develop a culture among its employees of understanding and managing risk so that in the future credit services can be offered at less expense, with greater agility and with better results.
- The operations officer must document his findings and analyze loan reviews with the regional managers to improve weaknesses in the current process. By intensifying the number of reviews and by carrying out a careful selection and analysis of loans before going to the field to verify his work he will improve his effectiveness.
- Although it has improved, the documentation found in the credit files is still deficient in many cases. Some files are not complete and in other cases and in others the lack of diligence on behalf of the loan officer is evident. The process of re-training all personnel is an on-going task.

- The loan officer must insist on the initial orientation and training of all new members to the village banks. FINCA should not accept allow individuals to join a village bank without this prerequisite, since it affects the consolidation of the groups.
- The loan officer should provide a summary of the village banking concept to all new members as part of their orientation. This is useful so that they are reminded of their commitments and of the characteristics of the loans that they might receive.
- The by-laws and the credit regulation of the village bank should be presented and signed as one document (one signature) in the official records of the village bank and not as two separate documents as it is done now.
- The loan officer / promoter of the village banks can better perform her job by: promoting within existing communities, obtaining better information on the members in the formation meetings, participating in the reorganization of village banks that are in need of it, insisting on the orientation session for all new members of a village bank, updating their portfolios for the formation of the bank, and delivering support materials to the members.
- The credit committees could improve their performance by: analyzing the categorization of members at different times; reviewing the risk characteristics of the members that leave and of the ones that stay; monitoring the behavior of the group's savings; carry out ongoing reviews of the village banks and its members in meetings in which their commitment, level of consolidation or deterioration may be observed; speaking with members to obtain relevant information concerning their businesses; by visiting businesses that require bigger loans to verify their capacity to pay. It is important that the credit committee at the village bank be formed and operating before a loan is actually granted.
- A greater level of control must be put in place for the loan collectors since presently there is almost nothing in place. A control file card of the payments that they make per client and follow up visits with clients for verification purposes will help to maintain a control and avoid cases of fraud or embezzlement. A control file card was developed with FINCA's legal counsel for this purpose.
- The checks that are given to the regional offices must be counted and administered in these offices under tight security conditions to avoid their loss or misuse.
- FINCA's client negative list must be maintained and followed among members of the village banks. There have been several cases of loans being made to members of a village bank that had not re-paid their loans while members of a previous bank. This recommendation should be implemented as soon as the portfolio tracking system has been migrated to Windows.

- Establishing a third signature in the savings accounts of village banks at the commercial bank is advisable in case one of the principal signatures can not be obtained. This measures will help to avoid one of the problems that has groups when one of the signers is not present.

c. Impediments on the formation of new groups

- The implementation of the decision to not allow loan officers that have a fifteen day past due portfolio of 2.25% to form new village banks may bring about negative consequences, especially when almost 60% of the loan officers fall into this category as of June 30, 2001.
- If they do not achieve fall under 2.25% in a short term, they would become unproductive and costly for the entity.
- An alternative could be to raise the goal to 5% while at the same time stepping up the supervision of these loan officers so that the new groups formed by these loan officers may be better analyzed to avoid risks.

d. Internal Audit

- It is necessary that this department have the support of the executive directive as it demands responses to the reports that are required, applying sanctions in those cases where warranted. This will greatly strengthen the authority of the auditors, making them more effective in minimizing risks and correcting repeat problems that are reported.
- The auditors will their effectiveness by making specific recommendations on their findings and by working as a team with management, operations personnel and credit personnel in the development and application internal control policies designed to manage the risks inherent to this type of activity.
- Auditor visits to clients in arrears must take on a broader role than just verify the reasons for falling in arrears. This type of visit, as well as visits to clients that are complying with their payments, should serve to confirm the existence of the client and the business, adherence to the institutions policies, the capacity of the client to pay the existing loan, the investments made with the loan, and the degree of satisfaction with the service provided.
- The audit function is an essential element in the development of a culture of managing risks in FINCA Honduras and as a result this function must integrate itself more fully in the operations of the institution in the future.

- e. Budgeting and the cost of serving the client
- FINCA must implement the budgeting and control process that will allow it to develop profit centers and areas of responsibility that can be used to monitor profitability and efficiency.
 - The current budgeting system, which consists of one institutional budget impedes good decision making. At this time, management does not have the tools to understand where it is incurring greater costs in relation to its actions and results. The current system also does not allow for the proper delegation of authority by its management.
 - The implementation of this recommendation will form the base that will allow the regional managers to begin to participate in the design and administration of their budget so that FINCA can eventually focus on the management of these regional or branch offices as profit centers, better preparing it for the regulation under the new FPVO law which will go into effect next year.
 - A simple Excel has been developed which can be used to analyze the cost of implementing certain decisions. The Excel file has been delivered along with this report so that it can be analyzed and modified if necessary for use by management.

D. ANNEX D - EXECUTIVE SUMMARY: REPORT ON THE CONSULTING ASSIGNMENT IN FINCA IN OCTOBER OF 2001

Consultant: Henry Cardona

The report covers a the description of the main activities developed during the assignment carried out by CARANA consultant Henry Cardona for FINCA Honduras during the period from September 17 to October 19, 2001.

1. Major activities completed

- Completion of a training program for loan officers on improving the credit analysis carried out on potential clients in an ongoing effort to improve the quality of the loan portfolio.
- All the topics and specific tools were first applied in the field by our consultant in the presence of loan officers and supervisors to demonstrate their practical application. In later phases of the training, our consultant observed the loan officers and supervisors as they applied the tools with their clients, be it in the formation of new village banks or in the analysis of new loans within those banks.
- Development of a workshop based on actual field cases, the design of exercises and the application of a final review of personnel being trained in order to verify the level of understanding.
- Improvement of the billboards and promotion material used during the formation stage of new village banks.
- Preparation and training of the loan personnel in the area of creating new village banks given the decision by FINCA to eliminate the specialization among staff in forming new village banks in January 2002. Effective December 2001, the loan officers will be carrying out this task as well.
- Revision and additions to the market expansion plan to be developed between the months of October and December of the 2001.
- Reorganizing of the activities of the credit committee to be able to undertake field visits and review decisions related to credit applications based on this field knowledge. This also will provide greater feedback to the loan officers and field supervisors which should lead to improved performance and risk management.

- Implementation of improved record keeping on the socioeconomic status of the village banking members with the purpose of substantially improving the scarce information that FINCA possesses on their clients. This will also allow for better record keeping at the individual client level which will lead to better decision making on new loans in the future. This is also necessary to improve the controls which will make it more difficult for members that have not complied in the past to move to another village bank and obtain a new loan.

All these actions are more fully developed in the consultant's report along with copies of the training material developed during this consulting assignment.

In agreement with the executive director of FINCA, the consulting assignment was carried out in the constant presence of the assistant credit manager so that they could replicate this same training exercise in other branches of the bank in the near future. The person responsible for providing follow-up on this assignment undertaken in the San Pedro Sula region is the business manager with support from the operations manager for this region.

E. ANNEX E - EXECUTIVE SUMMARY: REPORT ON THE TECHNICAL ASSISTANCE AND TRAINING PROGRAM CARRIED OUT IN WORLD RELIEF DE HONDURAS FROM JULY THROUGH DECEMBER 2001

Consultants: Elvis Alva; José Luis Lozano

1. Strengthening Credit Operations

The focus of CARANA's assistance to World Relief of Honduras (WRH) has been the strengthening of the credit process. To facilitate the implementation of suggested improvements and procedures, a Project Committee was formed within WRH with the autonomy to approve the new credit evaluation formats and procedures. This Project Committee also is working on revising and preparing a draft of the credit regulations for WRH. As a follow-up to this work, the Executive Directive, working in conjunction with the Project Committee, made the decision to implement these new procedures and formats in the branches located in the Tegucigalpa region.

The revised credit regulations are now being reviewed by the Executive Director of WRH and are expected to be approved shortly. Some of the major highlights these revised credit regulations include:

- The revision to the credit regulations introduce the possibility of new credit products within WRH. These include specific seasonal products for both working capital and consumer loans for active clients. A third product, a consumer credit product for clients that earn a fixed salary, is also proposed.
- Acceptance of the specific recommendations made with respect to the decentralization of the credit decision by the Committee on Credits and Levels of Autonomy. This is scheduled to be implemented in the first quarter of 2002.
- The adoption of a system for the classification of the clients that is partly in accordance with the guidelines established by the Superintendency of Banking and Insurance. This is an important first step in a process of complying with the requirements for eventual supervision under the new FPVO law.

The simplification of the credit evaluation process and of the forms used was one of our key recommendations in a process designed to streamline the credit process. After a final revision of the revised credit process and forms, a training program was developed to help implement these changes.

- A training session on the analysis and evaluation of operating costs was prepared and delivered. The purpose of this event was to reinforce the learning process and understanding of these costs and how they relate to profitability of the microentrepreneur.

- A training program on the new credit process and forms was also carried out with the branch supervisors and loan officers. This was done in the field using visits to real clients. This training also served as a planning stage for the pilot program to be carried out for a limited period of time. The pilot program itself will help the branch managers and loan officers better understand the new simplified credit procedures and forms.

2. Operating Plan for 2001

In addition to the above, CARANA has also supported WRH in the preparation of the Annual Operating Plan for 2002. Working jointly with their staff, a revision of WRH's Vision, Mission and Strategic Objectives was realized, identifying the specific strategies that will be required in order to achieve the goals established for 2002. These specific strategies include: a) a significant reduction in the client desertion rate; b) a reduction in the loans in arrears rate; and c) an increase in the overall loan portfolio and number of clients served by WRH.

As part of the above process our consultants also participated in developing a series of projections on client growth and client desertion under different scenarios. This will be used to monitor the evolution of the loan and client portfolio in 2002, and is part of an improved monitoring system which will help management better track these and other variables such as loan delinquency.

F. ANNEX F - EXECUTIVE SUMMARY: REPORT ON THE TECHNICAL ASSISTANCE AND TRAINING PROGRAM CARRIED OUT IN THE COVELO FOUNDATION (RETAIL CREDIT OPERATIONS) FROM JULY THROUGH DECEMBER 2001

Consultants: Elvis Alva; José Luis Lozano

1. Introduction

In coordination with the credit manager of Covelo's retail credit operations, a decision was made to assist Covelo with the implementation of our recommendations made in our report provided to Covelo in the first semester of 2001. A high priority was assigned to providing assistance in the streamlining of the credit process, as well as in developing a new incentive system for loan officers, and assistance in the marketing area.

2. Simplification of Credit Procedures and Formats

Specific assistance in this area included:

- The revision of the recommended formats and procedures with the credit manager and the deputy managers for the solidarity and individual lending programs.
- The further review and revision of the recommended formats and procedures with the branch managers of the Guanacaste and Pedregal offices. The suggested changes as a result of these two revision steps served to modify the proposed procedures and will help in facilitating the implementation process.
- The implementation of a training program for the managers and loan offices of the Guanacaste and Pedregal offices.
- At this time the revised formats and procedures are being tested in the field prior to the initiation of a pilot program to be conducted in the two selected agencies.

3. Incentive Plan for Loan Officers

A draft of the basic incentive plan for loan officers detailing the specific calculations was presented to the credit manager so that it can be reviewed and presented to the general manager for final approval. As part of this process, our staff made a presentation to Covelo's management on the advantages that this plan has to offer with respect to impact on the loan portfolio (net increase in loans, improved quality) and as a tool for monitoring the evolution of the loan portfolio over time.

At this time, the incentive plan is being reviewed by Covelo's management and pending final approval.

G. ANNEX G - EXECUTIVE SUMMARY: REPORT ON THE MARKETING ASSISTANCE PROVIDED TO FUNDACIÓN COVELO -

Consultant: Luis Ludeñas

1. Introduction

Fundación Covelo is one of the most important microfinance institutions in Honduras. It has a physical infrastructure made up of a main office and a 17 branches, and is supported by a capable staff of managers and staff and line personnel. Over the years it has demonstrated a respectable growth rate in both its total loan portfolio and in the number of clients.

2. The Market for Microfinance in Honduras and its Potential

Fundación Covelo has been growing in a market which is characterized by greater competition from established microfinance institutions in addition to the establishment of new competitors. This has resulted in a more competitive marketplace which in turn requires new strategies that meet the demands of this evolving marketplace and clients.

This consulting assignment was carried out from a marketing perspective, and is based on market and institutional information that was made available to the consultant at the time of this study. One of the first steps was to estimate the size of the microfinance market, and the market share that Covelo has achieved vis-à-vis the total market and its competitors. The basis of this work was the market study contracted by Covelo in 2000.

The consultant estimated that Covelo's retail operations currently maintain a market share of 6% of all urban small and micro entrepreneurs, however, the analysis also allowed the consultant to estimate market coverage in specific branch locations. For example, it was determined that Covelo's market share in Cortes is 13%. More importantly, the information extracted from this market study can be used to develop strategies for specific market segments, for countering competitor's initiatives, and will also support the decision making process in Covelo's plan for developing its branch network (transfers, closures and new locations).

3. Evolution of Covelo's Retail Operations

Up through 2000, Covelo had been growing faster than the rate of growth in the market, and as a result, it has been gaining market share over time. However, during the first six months of 2001, Covelo's loan portfolio only grew by 4%, vs. a market growth rate of 25%. Should this continue through the rest of the year, 2001 will show a decrease in market share for this institution.

The same situation is paralleled when analyzing the growth in the number of clients. After growing at a faster rate than the market through 2000, Covelo's clients increased by

9% in the first half of 2001 vs. a growth rate of 14% for overall clients in the marketplace. The above signals a decline in productivity and growth in Covelo which needs to be addressed in the short term.

4. Covelo's Branch Network

The analysis carried out on Covelo's branches concluded that very few of its branches have been able to meet their monthly targets in terms of loans placed and number of clients.

While one could conclude that maybe the targets were poorly set, upon further analysis, it became clear that the problem lies in the branches themselves. Ten of Covelo's seventeen branches (59% of the branches) are responsible for 80% of loan portfolio and 75% of Covelo's client base. Among the less productive branches we find that some of the older more established branches are performing below the levels achieved by some of the newer branches - not a common trend.

A very slow client growth has been observed recently as well. On average, a branch is capturing twenty new clients a month. Given that on average there are four loan officers per branch, this works out to an average of one new client per loan officer every five days.

An analysis of Covelo's loan officer productivity vs. that of its competitors revealed that Covelo's loan officers are administering average loans which are much higher than those of its competitors (Lps. 1.1 million for Covelo vs. an average of Lps. 654,000 per loan officer among its competitors), although some of its competitors have achieved as much as Lps. 1.8 millions per loan officer. In part this reflects the fact that Covelo's loan products (solidarity and individual loans) are geared for this upper end of the microfinance market vs. some of its competitors that are very much oriented towards village banking.

When analyzing the number of clients per loan officer, we find that Covelo's loan officers manage an average of 160 clients vs. 205 clients per loan officer on average for its competitors. Covelo's figures are among the lowest, however, these figures also reflect the fact that Covelo's loan officers are dealing with solidarity and individual loan products and not village banking. However, when compared to similar organizations in other countries, it is clear that Covelo needs to increase the productivity levels among its loan officers.

Covelo currently has an incentive plan for loan officers designed to boost productivity, however it only a few loan officers actually have access to this incentive system. This incentive program is based on an index of loans in arrears, number of clients managed, and loan portfolio administered.

5. Recommendations

As a result of this consulting assignment, the consultant made the following proposals to Covelo's management. These recommendations are detailed in the main body of the consultant's report.

- Implementation of improved tools for tracking the productivity of each branch and loan officer within each branch.
- Improved planning and reporting systems which will allow for the more efficient utilization of the loan officer's time in the field and which provides more timely information to management on the loan officer's efforts.
- Introduction of a new incentive system to be used with a group of loan officers which sets a very low fixed salary and a relatively high variable commission based on performance. This incentive system has already been proposed to Covelo's management and is pending their approval.
- The eventual introduction of a group of officers dedicated exclusively to sales (capturing new clients / new loans).
- Introduction of a specific marketing campaign motivating current clients to provide referral clients to Covelo.

H. ANNEX H - EXECUTIVE SUMMARY: REPORT ON THE TECHNICAL ASSISTANCE AND TRAINING PROGRAM CARRIED OUT IN HERMANDAD DE HONDURAS FROM JULY THROUGH DECEMBER 2001

Consultants: Elvis Alva; José Luis Lozano

1. Introduction

During the second semester of 2001, CARANA's technical assistance and training for Hermandad de Honduras (HDH) focused on two main areas. The first was the development of a manual for the introduction and maintenance of a loan officer incentive program. The second area of support was in the development of a market analysis in the geographic zones that HDH is present. Some limited support in streamlining credit procedures was also initiated.

2. Loan Officer Incentives

A manual presenting the basic incentive plan for HDH along with a calculation tool developed in Excel was developed and presented to management for approval by the Board of Directors of HDH. In support of this effort, presentations were made to the members of the Board of Directors, the general manager, the credit manager, and the loan officers explaining how the incentive program would work and what the advantages to the organization and the loan officers were. This incentive system is designed to motivate the loan officers who capture new clients, retain existing clients, and maintain high loan quality standards. The variables that determine the amount of the incentive will be adjusted periodically once the organization has gained some experience with this incentive tool.

3. Assistance in Market Analysis

During the semester a market study was carried out to analyze the productivity its loan officers and to determine the size of the potential market, which once defined was useful in measuring market penetration and market share. This study was carried out with the active participation of HDH's management and staff, and was successful in defining potential market and market share by municipality in the geographic areas covered by HDH as well as in new areas where HDH is considering expanding.

This study was also presented to all levels of the organization and served as the basis for a work plan developed by management aimed at increasing market share in existing areas of influence. The study also provided the information on new markets (Intibucá, La Paz an Santa Barbara), which are targeted in the institution's five year plan from 2002 to 2006.

4. Additional Assistance

Our consultants recommended to management that HDH create a real managerial and planning separation between the micro and small credit portfolio and the agricultural credit program which HDH also maintains. The separation was recommended given the vast differences in risk and characteristics of both types of lending which call for separate management, planning and monitoring.

Our consultants also provided a preliminary set of proposals designed to modify HDH's credit regulations and streamline the overall process. This was carried out as a complimentary activity of the overall effort to assist HDH in the transition to a regulated FPVO under the new law in Honduras.

I. ANNEX I - EXECUTIVE SUMMARY: REPORT ON THE TECHNICAL ASSISTANCE AND TRAINING PROGRAM CARRIED OUT IN THE ORGANIZACIÓN DE DESARROLLO EMPRESARIAL FEMENINO (ODEF) FROM JULY THROUGH DECEMBER 2001

Consultants: Elvis Alva; José Luis Lozano

1. Introduction

CARANA's technical assistance and training for the Organización de Desarrollo Empresarial Femenino (ODEF) during this semester focused on assistance in developing the operating plan for 2002 and in marketing. The marketing activities were carried out by our consultant Luis Ludeñas and is the subject of a separate report which is summarized in Annex J of this report.

2. Annual Operating Plan for 2002

CARANA consultants worked with management to support the development of the annual operating plan for ODEF. The process began with a review of the Vision statement, as well as ODEF's mission and strategic objectives. Specific strategies were developed to assist ODEF in meeting its targets for next year focusing on a reduction in client desertion, a reduction in loan delinquency rates, and a new marketing push to increase market penetration and market share. The enthusiastic participation by management, branch managers and loan officers culminated in the development of a printed mission statement which outlines ODEF's commitment to its employees and clients.

Using information from a report which was prepared on the criteria for measuring and tracking results, a detailed projection of client growth was prepared. This projection included various scenarios tracking the entry of new clients as well as the loss of old clients so that ODEF's staff would have a greater understanding of the dynamics affecting growth. One of ODEF's major initiatives for 2002 will be a decrease in the client desertion rates which is also expected to impact on the quality of the overall loan portfolio. This analysis also led to changes in ODEF's credit policies in order to stimulate greater growth.

Also as a result of the overall planning process, ODEF's management requested CARANA's assistance in developing a training program to be implemented in December with an eye towards better preparing their staff for 2002. As a result, CARANA staff delivered a series of training sessions on December 18 - 20 and on December 26 - 28. The training covered such topics as sales, organizational climate, changes in credit policies, and other related subjects. The sales workshop was specifically targeted at branch managers and was designed to strengthen their skills in directing the sales of ODEF's credit products within their respective branches.

J. ANNEX J - EXECUTIVE SUMMARY: REPORT ON THE MARKETING ASSISTANCE PROVIDED TO THE ORGANIZACIÓN DE DESARROLLO EMPRESARIAL FEMENINO (ODEF)

Consultant: Luis Ludeñas

1. Introduction

The Organización de Desarrollo Empresarial Femenino (ODEF) has been in existence since 1992, and until recently has shown consistent growth. After almost eight years of steady growth, in 2000 ODEF showed a decline in the number of clients although the overall portfolio grew thanks to the expansion of the individual credit products which carry a higher average balance than its village banking products which it has been de-emphasizing and which has also suffered from a high client desertion rate. ODEF's problems with client desertion can be summarized by the fact that since its inception in 1992, it has serviced a total of 19,256 clients of which more than half (10,436) are no longer clients of ODEF.

2. Analysis of the Loan Portfolio

ODEF's loan portfolio is made up of three basic loan products; village banking, solidarity lending and individual loans. A distribution of clients shows that 19% are village banking clients, 71% are solidarity group borrowers and 10% are individual borrowers. Village banking clients have been declining over the last two years, however solidarity and individual borrowers have continued to show some growth.

The analysis of the loan portfolio by loan product reveals a common tendency among microfinance institutions - that is that the largest number of borrowers (village banking) generate the smallest loan portfolio. Upon further analysis, however, it became apparent that while ODEF appears to be abandoning the village banking methodology, it still offering loans of a size associated with village banking in its solidarity and individual credit programs. This could generate problems in the future for ODEF in the future if not adequately monitored given that the work load for a loan officer is very different when overseeing 100 clients in a village banking program than when overseeing 100 clients in a solidarity or individual credit program.

As a result of the above, our consultants have recommended to ODEF's management that they need to have a better understanding of the work load and cost of administering loans of different sizes under different loan programs. This would be a first step in the introduction of a differentiated pricing schedule for loans which is based on the cost of placing and administering these loans. Currently, ODEF charges a single rate of 36% for all loans under L 50,000 regardless of loan program.

When reviewing the loan portfolio by branch our consultants also observed a wide range of results with regards to the productivity achieved. While differences are normal given

the characteristics of each market, the length of time a branch has been operating, and a number of other variables, in ODEF's case our consultants saw variances that were more a result of productivity variances. Unfortunately, ODEF has not developed goals and targets for its loan officers by loan product and as a result it has no way of really measuring the productivity of the loan officers within a branch, and as a result, of the branch itself.

Further aggravating the problem is the fact that ODEF does not have a very sophisticated loan officer incentive program in place. Currently, loan officers receive a fixed compensation, although there is an incentive program in place aimed at reducing loans in arrears. The incentive program does not address the capturing of new clients, the retention of existing clients, and is not directly tied to loan officer productivity.

3. Recommendations

Among the recommendations made by the consultant were:

- Introduce a new compensation system for existing loan officers with a variable component designed to increase loan officer productivity, and make it available to more loan officers in ODEF.
- Introduce a new compensation system with new loan officers (Junior Loan Officers) with a very low fixed compensation scheme and a very high variable component designed to increase loan officer productivity.
- Introduce different interest rates by loan product taking into consideration the cost of placing and administering the loans, shifting away from the single loan rate currently in use by ODEF.
- Implement a specific action plan to minimize client desertion.
- Implementation of improved tools for tracking the productivity of each branch and loan officer within each branch.
- Improved planning and reporting systems which will allow for the more efficient utilization of the loan officer's time in the field and which provides more timely information to management on the loan officer's efforts.

K. ANNEX K - FINSOL: EXECUTIVE SUMMARY: ADMINISTRATIVE STRUCTURE, ORGANIZATION MANUAL AND SALARY SCALES FOR FINSOL

September 2001

Consultants: Hugo Velarde, José Luis Lozano, Elvis Alva

1. Introduction

FINSOL S. A. is a microfinance institution that has been operating for two years as a "financiera" under Honduran banking legislation. It is unique in that it is the only microfinance organization in Honduras that currently is regulated and that has the ability to accept deposits from the general public.

While FINSOL has made the transition from a non-regulated FPVO (previously FUNADEH) to a formal financial institution, it still operates in many ways as an informal FPVO. One of the areas where it has asked for assistance, and which is the subject of this report, is in the organization and administrative structure of the institution. Specifically, this report provides a written description of the overall organizational structure, the functions and responsibilities of each one of the positions in the organization, and salary scales - all of which did not formally exist within FINSOL. This work has been developed taking into consideration the environment in which FINSOL operates, and the institutional goals and objectives as described by management.

A summary of the main points contained in this report, which are further detailed in the body of the report, are presented in the sections below.

2. Organizational (Functions and Positions) Manual

A organizational manual (functions and positions manual) was developed as part of this report and presents the job descriptions and specifications for each position in FINSOL looking to optimize its human resource potential. This manual should be analyzed by the general management of FINSOL, and then once reviewed and approved, should be formally approved by the Board of Directors so that it can be adopted and implemented across the institution.

For each position in the organization, the attached functions and positions manual provides the following:

- Title
- Department
- Number of positions
- Direct supervisor
- Subordinates
- Summary of the position

- Responsibilities and authority
- Criteria for performance evaluation
- Work requirements / environment
- Specific detailed job responsibilities and specifications

It will become management's responsibility to utilize this manual, particularly through the implementation of a formal employee review program, to measure employee effectiveness and contribution towards the goals of the institution. Financial and non-financial incentives, including training and development, specific fringe benefits, etc, to be developed by management over time would supplement this organizational manual.

3. Procedures Manual

As a complement to the organizational manual, management should also consider the preparation of administrative policies and procedures for each position. The main purpose of this manual would be to support personnel by providing them with written policies and procedures for the functions that are carried out in their respective positions.

4. Position point / weight system

The point system described in greater detail in this report is a methodology used to provide a weight for the "value" of each job position. It is used to develop a consistent salary scale throughout the institution based on specific job conditions. In this case it was developed based on an analysis of the ability, effort, responsibility and work conditions of each position. A description of how this system was developed for FINSOL is presented in Annex 1 of the report.

5. Proposal for Salary Scale

In developing the proposed salaries for each position, the current salaries within FINSOL S.A. have been considered, along with salaries for similar positions and responsibilities in labor market for this type of institution. Changes in the future to the salary scale presented in the report would be based on the growth of the loan portfolio, future profits, and the achievements of the strategic goals and targets of the institution.

6. Recommendations

Management and the Board of Directors needs to review, approve and apply the proposed organizational manual as soon as possible. The application of this organizational manual is central to the overall effort to define and strengthen the global human resources function in FINSOL which includes the following areas which are currently managed in an ad-hoc manner: Human resources planning; recruitment, selection and hiring of personnel; human resource training and development; performance reviews and salary adjustments; and, promotions, transfers and or termination of personnel.

L. ANNEX L - EXECUTIVE SUMMARY: DIAGNOSTIC REPORT ON THE SIEM MANAGEMENT INFORMATION SYSTEM

September 2001

Consultant: Hugo Velarde

1. Introduction

This diagnostic evaluation of the Specialized System in Micro Credits. - SIEM system - was carried out in five FPVOs (Covelo, FINCA, WRH, ODEF and HDH), all of which use this system, originally developed in Guatemala. The main purpose of the evaluation was to identify the strengths and weaknesses of this system, and to assist in helping these and other FPVOs in Honduras decide on a common MIS strategy for the future if possible. The evaluation is particularly timely in light of the new law governing FPVOs which will require Honduran FPVOs to strengthen their management systems, their internal controls and their reporting ability.

Although it was understood that all five of these institutions use the same software, they all have different versions of the software. While some of the problems inherent in this software are common to all, some problems are institutional specific. In these cases, the institution's MIS staff have developed their own unique solution to the problem thereby making each system even more unique.

2. Methodology

The work plan called for the consultant to spend 4 days with the management and the MIS staff of each of the five FPVOs and was designed to accomplish the following:

- The first day was spent with the MIS manager and with the MIS staff that worked on the credit process. This was used as an initial meeting to gather their impressions regarding the overall system as well as its advantages and disadvantages. The consultant then familiarized himself with the system at the institutional level (platform, version, specific reports, problem areas, technical support, etc.).
- The second day was spent with the managers of the credit and finance departments. In addition to discussing the system's strengths and weaknesses, the consultant also analyzed what information and reports they were using from the system as well as how they used these reports in the decision making process.
- The third day was spent with the accounting department which allowed the consultant to understand how the overall accounting system integrated with the SIEM system. This was also useful to the consultant in understanding some of the principal weaknesses of the system.

- The fourth day was spent in a meeting with all of the managers from the previous three days. This meeting was useful in clarifying questions that the consultant had. During this meeting the consultant presented his initial report, discussing the strengths and weaknesses of the MIS system. The consultant also discussed what an ideal MIS should offer a microfinance institution.

Highlights from the consultant's report, presented in its entirety to USAID and the participating FPVOs in September 2001, are discussed below:

3. General System Issues

- Not all institutions are running the software on the same operating platform nor are they all running the same software release. Some institutions are running SIEM in Visual (Visual-Fox) while others are using a DOS platform (Fox-Pro). It is recommended that all institutions use the same version and platform.
- All of the FPVOs have created their own reports outside of the system given that the system can not be modified and yet the software does not have adequate reporting capability. Creating reports outside the system is not recommended as it can lead to errors in data.
- The system is not very efficient in the inputting of data, particularly data that comes in from the branches (manually). The lack of adequate data transmission capability and infrastructure means information is being sent on disk and on paper. This results in information having to be processed and verified again at the central office before being sent back to the branches for re-input at the branch level.
- Client loan payments (made through commercial banks) are not handled adequately by the system. The SIEM system does not provide for in-house cash receipts.
- When a loan is refinanced or restructured, the system treats this as a new loan and the old loan is recorded as having been paid off. Refinanced or restructured loans are not identified as such by the system. When loans are cancelled, there is usually a balance left on the old loan (accrued interest), which must be cleared out manually.
- The SIEM system does not provide a calculation for loan officer incentives. This has to be done manually outside the system which leads to errors.
- The system allows a user to manually modify the data base without a control or documentation process. This is a major shortcoming of the system, as it does not create an audit trail - a necessary internal control practice.
- Software patches made by the software company responsible for the SIEM system (Soft-Corporation in Guatemala) have not been satisfactory in some cases.

4. The Credit Process / Credit Department

- The system does not generate timely information at the branch level where it is most needed (individual loan balances, portfolio analysis, etc.). This results in poor service and many delays in the approval and disbursement process.
- The system generates a client number by branch, but it is not a unique, institution wide, client number. This does not allow for the tracking of individual clients at the bank level. A unique client number to be used for all transactions with the FPVO is necessary for reporting purposes (bank supervision) and makes it difficult for the bank itself to track individual client behavior.
- The credit evaluation is not stored on-line as part of the clients record. Only approved loans are registered. As a result, a great deal of valuable information is lost.
- The entry of client's names are not standardized, which sometimes results in the same client showing up as two separate individuals in the system.
- The search and access capability of the software for clients and loans is very inefficient. Access is by approximate search (LIKE) given that the data is not stored in alphabetical form. This makes it difficult to carry out a quick and accurate search and also affects the reporting capability of the software.
- The system does not track information on the client's spouse or immediate family. This is necessary since there are usually more than one borrower in a family, although the family as a whole may make up an economic unit (depend on one business). This is a risk management tool.
- The system does not register information on the guarantee being offered by the client. This is important in the post review of loans to verify that loan amounts do not exceed the capability to pay and/or offer guarantees.
- The system does not check approved credits or client's names against a "negative list" of clients. The negative list itself is not actively maintained. The list contain all declined credit applications, all clients that have not complied with loan terms and conditions, clients that have defaulted and / or had collection actions taken against them. This is a very important risk control mechanism that should be maintained and consulted as part of the credit approval process. Eventually, this information should also be made available to the credit bureau which has been established in Honduras.
- The SIEM system can not generate a new payment amount when a client is past due and requests new amount due including additional interest. This calculation is done manually at the branch, which is time consuming and inaccurate.
- The central credit committee does not have ready access to all of the information which it ideally should in order to properly review or grant a credit. Ideally, all of the

required information should be available on line (history, behavior, credit analysis, etc.).

- The documentation on loan disbursements is not standardized in all branches. Errors in interest calculations were observed as well.
- The system can not generate the overall position or exposure of a client (or client's family) with the institution. The system should be able to generate such a report on a daily basis.

5. Finance

- The system does not generate adequate reports that would allow the finance area to carry out its planning functions properly. A review of existing reports generated by the system revealed some errors in the data. An integrated management reporting system (loan balances by fund type, bank reconciliations, cash availability and demand) is necessary for the timely decision making process.

6. New Product Development

- The SIEM system does not allow for the easy integration of new loan products. Each new product requires a modification which must be carried out by the software provider in Guatemala. FPVOs have complained as to the cost and lack of service.

7. Accounting

- In all institutions the consultant was able to observe important differences in the balances maintained by the SIEM system and those in the accounting system. These differences have to do with limitations or deficiencies in the SIEM system

8. Recommendations

Three possible alternative solutions to the SIEM system are proposed which would require the development of new software and acquisition of additional hardware, and the technical specifications are detailed in the main body of the report. Highlights of the recommendations are as follows:

- The software solutions should be developed in a programming language that is easy to manage and maintain (Visual Basic and RPG/ILE) and which are readily available and understood in Honduras.
- Initially such a system would be run on an AS/400 in the central office with SQL/Server data base manager at the branch level running on PCs, however, it would be possible to start out with an even less sophisticated home office system running on PCs initially.

- The software should also be open allowing the institution to readily access it to be able to modify it to their own requirements rather than having to return to the software vendor for each modification or addition.
- Communication between the central office and the branches would also be off-line, but via modem or physical exchange of disks. In the long run the system should be able to work on-line, however, for this to be a viable option, the infrastructure in Honduras

M. ANNEX M - EXECUTIVE SUMMARY: COURSE ON THE SUCCESSFUL EXPERIENCES OF MICROFINANCE INSTITUTIONS IN LATIN AMERICA

Consultant: Elvis Alva; Resident Advisor

October 2001

This course was carried out in Tegucigalpa Honduras in a three day period from October 18 - 20, 2001, and was attended by 25 students. The course is in support of a joint initiative by the Covelo Foundation and the University of Honduras to offer a Diploma in Microfinance through an accredited institution in Honduras.

The course was designed and delivered by Elvis Alva, long term resident advisor under the USAID microfinance support project. Mr. Alva offers a wealth of experience in the implementation of credit methodologies and development of financial products in Latin America, and also has first hand experience with the Honduran microfinance sector.

The course itself centered on the overall strategies of successful microfinance institutions in Latin America with a focus on the diversification of products and services to microentrepreneurs as a key element in the growth and development of microfinance institutions. The following institutions were highlighted:

- BANCOSOL - Bolivia
- MIBANCO - Peru
- Caja Municipal de Ahorro y Crédito de Arequipa - Peru
- Caja Municipal de Ahorro y Crédito de Piura - Peru
- FAMA - Nicaragua

The course covered various aspects of each institution's evolution and included such topics as the overall mission and strategy of each institution, the specific products used by each, and a discussion of some of their weaknesses or failings. Participants also received a series of handouts and additional information that they could use on their own.

N. ANNEX N - EXECUTIVE SUMMARY: COURSE ON THE MARKETING MIX IN MICROFINANCE INSTITUTIONS; CLIENT SERVICE - NOVEMBER 2001

Consultant: Luis Ludeñas

This course was delivered over a three day period from the 29th of November to the 1st of December 2001. A total of 41 participants attended the course which is part of the Diploma in Microfinance course being coordinated by the Covelo Foundation and the University of Honduras.

The consultant who delivered the course, Mr. Luis Ludeñas, is a marketing professional with extensive experience and knowledge in the development and implementation of marketing tools designed to promote new businesses and encourage client loyalty in microfinance institutions. Likewise, the consultant has worked with various microfinance institutions in Honduras and has an understanding of the environment in which these institutions deliver their services.

The main objective of this seminar was to provide participants with a greater understanding marketing in microfinance institutions and its use as a management tool to help meet the institution's objectives of growth and profitability. The course presented the principal objectives of the marketing function and the application of specific marketing strategies in response to those objectives. The course was based on case studies developed by the consultant and which were based on real situations. Among the principal topics covered in the course were:

- The marketing function, its relationship with the overall planning process and results;
- Competition and productivity; evaluating results, issues in measuring results and the impact on productivity;
- Market penetration and alternative strategies;
- Market research and the practical application of this research to achieve institutional objectives;
- Quality of service as a marketing strategy; and,
- Incentive plans for loan officers as a way to increase productivity, efficiency and profitability.

The course featured classroom lectures combined with group exercises based on theoretical and actual case studies. These group exercises also were designed to promote a sharing of information among the institutions present.